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No. 99-

IN THE

Supreme Court of the United States

NEW VALLEY CORPORATION,

Petitioner,

v.

CORPORATE PROPERTY ASSOCIATES 2 and
CORPORATE PROPERTY ASSOCIATES 3,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Does the doctrine of unclean hands bar a creditor from recovering in a bankruptcy proceeding where that creditor presented false testimony and manufactured documentary evidence but abandoned its scheme once discovered?

PARTIES TO THE PROCEEDING AND STATEMENT PURSUANT TO RULE 29.6

Petitioner

New Valley Corporation ("New Valley"). New Valley is a publicly held corporation. The principal stockholder of New Valley is Brooke Group Ltd., a publicly held company.

Respondents

Corporate Property Associates 2, and Corporate Property Associates 3 (together, "CPA"). According to information filed by Respondents below, Respondents are limited partnerships whose general partner and owner of more than 99% of limited partner interests is Carey Diversified LLC, a publicly held company.

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The opinion of the United States Court of Appeals for the Third Circuit is reported at 181 F.3d 517. A copy of the opinion and judgment is included in the Appendix at App. A at 1a-25a. The opinion of the United States District Court for the District of New Jersey is reported at 222 B.R. 722. A copy of the District Court's opinion and judgment is included in the Appendix at App. B at 26a-55a. The opinion of the United States Bankruptcy Court for the District of New Jersey is unpublished but can be found at 1997 Bankr. LEXIS 2193, 31 Bankr. Ct. Dec. 1168, and is included in the Appendix at App. C at 56a-101a.

STATEMENT OF JURISDICTION

The United States Court of Appeals for the Third Circuit issued its opinion on July 6, 1999. On July 20, 1999, Petitioner filed a timely Petition for Rehearing and Petition for Rehearing *En Banc* which the United States Court of Appeals denied on August 27, 1999 (Appendix E). This Petition for Writ of Certiorari is filed within 90 days of the denial of the Petition for Rehearing. The Court's jurisdiction is invoked pursuant to 28 U.S.C. §§ 1254(1) and 2106.

STATUTORY PROVISION INVOLVED

United States Code, title 11, section 502 is provided at App. F.

STATEMENT OF THE CASE

Since the early 1970s, Western Union Telegraph Company ("Western Union"), New Valley's predecessor-in-interest, had been the tenant pursuant to leases relating to certain properties located in Reno, Nevada (the "Reno Lease"), Moorestown, New Jersey (the "Moorestown Lease"), and Bridgeton, Missouri (the "Bridgeton Lease"). App. B at 27a-28a, App. C at 57a-58a.

In November 1981, CPA purchased the three properties and became Western Union's landlord. App. A at 3a; App. B at 27a-27b; App. C at 57a-58a. In December 1981, Western Union changed its name to Western Union Corporation ("WUC") and continued to be the tenant under the leases at the Moorestown, Reno and Bridgeton properties. App. A at 3a; App. C at 58a.

In August 1989, Western Union Financial Services, Inc. ("FSI"), formerly a division of Western Union, was created as a wholly-owned subsidiary corporation to hold a substantial portion of the assets of WUC's money transfer business. App. A at 3a; App. B at 28a; App. C at 58a. On April 18, 1991, WUC changed its name to New Valley Corporation. App. A at 3a; App. B at 28a; App. C at 58a.

On March 15, 1990, Donald Wasson, New Valley's Director of Real Estate Operations, wrote to Barclay Jones, then vice-president of CPA, to request that CPA consent to the assignment of the Bridgeton and Reno Leases to FSI. Wasson enclosed consent to assignment forms (the "Proposed Consents") with the letter. App. A at 4a; App. C at 79a-80a. In April, 1990, Wasson and Jones discussed the

Proposed Consents, at which time CPA stated that it would not sign the Proposed Consent unless the Moorestown Lease was also assigned to FSI. App. A at 4a-5a; App. B at 28a; App. C at 80a. New Valley would not assign the Moorestown Lease. App. A at 5a; App. B at 28a; App. C at 80a.

At trial, Jones testified "unequivocally" that New Valley and CPA had not reached any deal regarding CPA's consent to the assignment. App. C at 80a New Valley understood this as well; in April 1990, Wasson had sent a memorandum to his colleague, Jan Wolpert, in which he stated that there was no business deal with respect to the assignment of the Bridgeton and Reno Leases since CPA would not consent without the inclusion of the Moorestown Lease. App. C at 80a. Between April 1990 and May 1993, there were no further discussions about, or references to, any assignment of the Leases. App. A at 5a; App. C at 80a.

On November 15, 1991, an involuntary petition pursuant to Chapter 11 of the Bankruptcy Code was filed against New Valley. App. A at 6a; App. B at 29a; App. C at 61a. On March 30, 1993, New Valley consented to the entry of an order for relief and became a debtor-in-possession. App. A at 6a; App. B at 29a; App. C at 61a. Approximately one month later, New Valley sought approval from the Bankruptcy Court to reject its Moorestown lease. App. A at 6a; App. C at 67a. The Bankruptcy Court entered an order approving the rejection in May, 1993. App. A at 6a; App. B at 29a; App. C at 67a.

In April of 1993, New Valley filed an application for an extension of its time to assume or reject its remaining non-residential real property leases, including the Reno and Bridgeton Leases, until confirmation of a plan of

reorganization. App. 6a; App. B at 30a; App. C at 80a. CPA filed an objection to New Valley's application on or about May 14, 1993, arguing *inter alia* that a blanket extension of time until confirmation would be unfair to CPA and that such relief would undermine § 365(d)(4) of the Bankruptcy Code. App. A at 6a; App. C at 80a. On May 18, 1993, however, CPA advised New Valley that it would be withdrawing its objection on the basis that CPA had "discovered" that the Bridgeton and Reno Leases had been assigned by New Valley to FSI in 1990. CPA then executed copies of the Proposed Consents, backdated them three years to 1990, and faxed them to New Valley. App. A at 5a; App. B at 30a; App. C 81a-82a.

After confirming that New Valley had not previously received executed copies of the Proposed Consents, New Valley sent a letter to CPA's counsel setting forth New Valley's understanding that no assignments had been implemented with respect to the Reno or Bridgeton Leases and that New Valley remained the tenant under those Leases. App. at 5a; App. B at 30a; App. C at 81a. CPA's counsel responded in a letter that it was CPA's position that an assignment had indeed occurred and that New Valley was attempting to construct a "creative bankruptcy solution" in order to avoid FSI's liability on the Reno and Bridgeton Leases.[1] App. A at 5a; App. B at 30a.

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1. CPA's claims against New Valley, a Chapter 11 debtor, are capped at one year's rent pursuant to section 502(b)(6) of the Bankruptcy Code. By arguing that its tenant was FSI, CPA could assert a claim for the full remaining multi-year terms of the Leases without limitation. If successful, CPA could have asserted a breach of contract claim against FSI that would have been approximately $7 million greater than the claims it could have lawfully asserted against New Valley. App. B at 42a.

CPA then proceeded to file its initial Proof of Claim against New Valley in which it stated, under penalty of perjury, that:

> *Although the Bridgeton, Missouri and Reno, Nevada leases were assigned to and assumed by Western Union Financial Services, Inc. ("FSI"), a non-debtor subsidiary of the Debtor,* because the Debtor has taken the position in this bankruptcy case that the two leases were not assigned, CPA:2 and CPA:3 have included these amounts in its Proof of Claim as a precautionary measure. CPA:2 and CPA:3 hereby reserve the right to argue that the Bridgeton and Reno leases were in fact assigned to and assumed by FSI.

App. A at 7a; App. B at 31a (emphasis added).

CPA's motive for proceeding in this fashion was patent to all. As the Bankruptcy Court explained:

> CPA's course of action becomes more understandable when considered against the backdrop of New Valley's financial difficulties both pre-bankruptcy and afterwards. As New Valley points out, its lengthy history of financial difficulty and involuntary bankruptcy were well known. When New Valley filed its motion to extend the time to assume the Moorestown, Reno and Bridgeton Leases, and CPA had miraculously uncovered the executed consents, New Valley was in the early stages of its voluntary case, the outcome of which was unknown, and FSI was a solvent non-debtor subsidiary. The attractiveness

> of FSI as a tenant rather than New Valley is readily apparent. Again, as New Valley points out, Jones knew that while § 365 and 502(b)(6) of the Bankruptcy Code would limit CPA's claims in the New Valley bankruptcy, no such limitation existed if FSI was the tenant.

App. C at 86a.

At all times, CPA knew that the Leases had not been assigned to FSI, that New Valley, not FSI, was the party liable for rejection or breach of the Leases, and that CPA's ability to obtain damages would therefore be limited by § 502(b) of the Bankruptcy Code. App. C. at 79a-86a. CPA knew the leases had not been assigned to FSI because no assignment of the Leases could have been effective without CPA's consent, which it had never given. Therefore, after New Valley was in bankruptcy, and despite CPA's knowledge that there had never been an assignment, CPA manufactured evidence of its consent by signing and backdating a "Consent to Assignment" form that was originally prepared in 1990 in connection with a deal that was never consummated. Virtually all of New Valley's accusations against CPA were found by the Bankruptcy Court to be true, leaving no doubt about CPA's fraudulent behavior. App. C at 79a-88a.

After eight days of evidentiary hearings, the Bankruptcy Court found that, *inter alia*, CPA intentionally and falsely maintained that the Leases were assigned (App. C at 79a); CPA asserted that position as a "negotiating tactic" (*id.*); CPA "backdated and then produced [the consents] to avoid the prospect of being limited to a lease rejection claim in the New Valley bankruptcy" (App. C at 81a, 86a); "Jones' lack

of memory" was not "credible" (App. C at 85a); CPA's "lack of any explanation as to why CPA did not tender the allegedly executed consents to New Valley" was "remarkable" (App. C at 86a); neither "Jones or CPA as an entity were confused as to whether New Valley or FSI was the tenant" (*id.*); it is "inconceivable" that CPA did not know who the tenant was (App. C at 87a); and "expert testimony convincingly demonstrates that the consents were backdated" (App. C. at 81a-82a, 97a). CPA did not appeal from the Bankruptcy Court's underlying factual findings, which were adopted by the District Court.

Although the Bankruptcy Court declined to punish CPA for its fraud, the District Court properly concluded on appeal that, based upon the Third Circuit's opinion in *Gaudiosi v. Mellon*, 269 F.2d 873 (3d Cir. 1959), the Bankruptcy Court was in error. The District Court observed that although CPA's fraudulent claims were directed at FSI, CPA asserted a theory it knew to be false, manufactured evidence, and proffered false testimony concerning its conduct in New Valley's bankruptcy proceeding through proofs of claim and other pleadings, thus committing its fraud before the Bankruptcy Court. App. B at 52a-53a.

There was unrebutted evidence at trial that New Valley was actually harmed by CPA's attempted fraud. New Valley was obligated to indemnify FSI in full for any liability under the Leases[2], and it expended hundreds of thousands of dollars in defending, investigating and ultimately exposing as

2. New Valley's indemnification obligation arose because FSI was sold at the conclusion of New Valley's bankruptcy case as part of its plan of reorganization. At the time CPA first asserted its fraudulent assignment theory, FSI was still the wholly-owned subsidiary of New Valley.

fraudulent CPA's assignment claims. Of course, New Valley would necessarily have been severely harmed if CPA had succeeded in its scheme to nominally defraud FSI, because FSI was a wholly owned subsidiary of New Valley and the only significant asset of New Valley's bankruptcy estate. The District Court correctly ruled that it is abhorrent to the principles of bankruptcy jurisprudence that a creditor may come into a court of equity with unclean hands, and yet share in the assets of the bankruptcy estate. App. B at 50a-53a.

On appeal, the Panel reversed the District Court concluding that the facts did not establish a direct relationship between CPA's inequitable conduct and its claim in the Bankruptcy Court against New Valley for the unclean hands doctrine to apply. App. A at 18a, 21a-23a.

The Bankruptcy Court had jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and the Standing Order of Reference by the United States District Court of New Jersey, dated July 23, 1984, and because the matter is a core proceeding under 28 U.S.C. § 157(b)(2)(B). The United States District Court had mandatory jurisdiction to hear the appeal from the final order of the Bankruptcy Court pursuant to 28 U.S.C. § 158(a)(1) and Fed. R. Bank. Pro. 8001(a), and jurisdiction over the subject matter pursuant to 28 U.S.C. § 1334. Appellate jurisdiction in the Court of the Appeals for the Third Circuit arose pursuant to 28 U.S.C. § 158(d), 28 U.S.C. § 1291 and 28 U.S.C. § 1294.

REASONS FOR GRANTING THE WRIT

By holding that a fraudulent breach of contract claim asserted against a bankruptcy debtor's wholly owned subsidiary is not sufficiently "related" to a subsequent assertion of that claim against the debtor itself to implicate the unclean hands doctrine, the Third Circuit committed clear error. The Third Circuit improperly renounced this Court's longstanding precedent, established in *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245 (1933), that the unclean hands doctrine may apply so long as the inequitable conduct "in some measure affect the equitable relations between the parties in respect of something brought before the court for adjudication" in favor of a wooden rule that the inequitable conduct must be committed, and not abandoned, in direct pursuit of the claim.

The need for this Court to grant a writ of certiorari to correct the Third Circuit's opinion and ruling is acute, because it is not only New Valley alone that will suffer from the Panel's errors. Rather, the Third Circuit, perhaps inadvertently, has created a socially destructive rule that a litigant is free to behave dishonesty before the court without fear of reprisal or adverse consequences. The dishonest litigant can give its best efforts to succeed in its fraud, while maintaining the option to come back into court and recover by asserting a conflicting set of facts if the fraud should be discovered before trial. That is precisely what the Third Circuit permitted CPA to do here.

I.

THE COURT OF APPEALS' SEVERE RESTRICTION UPON THE CIRCUMSTANCES IN WHICH A COURT MAY APPLY THE UNCLEAN HANDS DOCTRINE CONFLICTS IN PRINCIPAL AND UNDERMINES THE PRECEDENTIAL VALUE OF THIS COURT'S DECISIONS IN *KEYSTONE* AND *PRECISION INSTRUMENT*

The July 6, 1999 opinion (the "Opinion") of the Third Circuit Panel (the "Panel") reversing the Order of the United States District Court for the District of New Jersey (Wolin, J.) barring CPA's claim for relief on the basis of unclean hands was erroneous and contrary to this Court's decisions in *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245 (1933) ("*Keystone*") and *Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co.*, 324 U.S. 806 (1945). The basis of the Panel's decision — that CPA's fraud and misconduct did not bear a sufficient relationship to the claims against New Valley — undermines the Supreme Court's prior holdings that the cause of action need not be the fruit of a party's misconduct, but such misconduct must only affect in some measure the equitable relations among the parties. In the instant case, the equitable relations among the parties can be summarized as follows:

(1) New Valley was a chapter 11 debtor;

(2) The value of New Valley's estate consisted almost entirely of the value of its wholly-owned non-debtor subsidiary, FSI;

(3) CPA was a creditor of New Valley by virtue of its status as New Valley's landlord;

(4) CPA sought to avoid the legal consequences of New Valley's bankruptcy by fraudulently asserting that FSI was liable under the Leases, and manufacturing evidence to support these assertions;

(5) CPA asserted its fraudulent theory in the Proofs of Claim filed in New Valley's bankruptcy proceeding, and in subsequent testimony and argument before the Bankruptcy Court.

(6) Had CPA been successful in perpetrating its fraud, (a) CPA would have been precluded from asserting its present claims against New Valley, while at the same time (b) the value of New Valley's estate would have been diminished by additional millions of dollars.

(7) CPA returned to court after failing in its fraud to seek to hold New Valley liable for those Leases.

Clearly, CPA's conduct affected the equitable relations of the parties as set forth in *Keystone*.

In *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245 (1933), this Court articulated the unclean hands doctrine as follows:

> It is one of the fundamental principles upon which equity jurisprudence is founded, that before a complainant can have standing in court he must first show that not only has he a good and meritorious cause of action, but he must come into court with clean hands . . . The governing principle is that whenever a party who, as actor, seeks to set the judicial machinery in motion and

> obtain some remedy, has violated conscience, or good faith, or other equitable principle, in his prior conduct, then the doors of the court will be shut against him in limine; the court will refuse to interfere on his behalf, to acknowledge his right, or to award him any remedy . . . The equitable powers of this court can never be exerted on behalf of one who has acted fraudulently, or who by deceit or any unfair means has gained an advantage. To aid the party in such a case would make this court an abetter of iniquity.

290 U.S. at 244-245 (citations omitted).

In *Keystone*, the plaintiff had alleged that the defendant was infringing upon five of its patents. The defendant there argued that the plaintiff's claims should be barred by unclean hands because the plaintiff had improperly suppressed evidence of a prior use of one of the patented devices in a prior infringement action against a different defendant. *Id.* 290 U.S. at 243. The district court, like the Bankruptcy Court here, concluded that the misconduct was reprehensible, and was motivated by an improper purpose. Nonetheless, the lower court did not bar the claim, finding that the misconduct as to the first patent was not related to the merits of the dispute as to the five patents at issue in the second action. On appeal, this Court adopted a broad view of the requisite relationship between the misconduct and the equity sought, and nullified all five patents, even though the improper conduct related to only one of them. *Id.* at 246.

Indeed, "[a]ny willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for invocation of the maxim."

Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co., 324 U.S. 806, 815 (1945); *see also Monsanto v. Rohm & Haas Co.*, 456 F.2d 592, 598 (3d Cir. 1972). There is simply no strict formula that limits the court's power to invoke the unclean hands doctrine, and one generally need only show the following for the doctrine to apply: (i) an unconscionable act; (ii) that *in some measure affects* the equitable relations between the parties; (iii) concerning something brought before the court for adjudication. *See Keystone,* 290 U.S. at 245.

Under the standard set forth in *Keystone*, the District Court's conclusion that "CPA's improper conduct was immediately and necessarily related to the equity CPA sought before the Bankruptcy Court and definitely affected the equitable relations between the parties" was correct. The unclean hands doctrine applies to parties who come into equity with unclean hands. *Keystone*, 290 U.S. at 244 (party "must come into court with clean hands"). CPA came to the Bankruptcy Court with unclean hands by filing a proof of claim that fraudulently misrepresented that FSI was liable, and proceeded to "support" the false position for many months with fabricated evidence and false testimony.

CPA also asserted the assignment "theory" it knew to be untrue in a manner that constituted a fraud on the Bankruptcy Court and an attempted fraud upon New Valley through, among other artifices, two sworn proofs of claim, discovery, motion, and litigation practice that CPA attempted to support with manufactured evidence.[3] CPA's failure to

3. The Panel expressed concern that the District Court had focused primarily on the Proposed Consents which related only to the Reno and Bridgeton Leases, but not the Moorestown property. (Cont'd)

succeed in fraudulently obtaining a ruling that FSI was liable under the Leases does not negate that CPA pressed a fraudulent theory. Both the Bankruptcy Court and the District Court held that the theory itself was a sham. *See* App. B at 52a; App. C at 79a.

The Panel's acceptance of CPA's argument that its proof of claim was a harmless reservation of rights to assert an alternative theory (App. A at 22a-23a) is a further error, which mutes the extreme malevolence of CPA's conduct and demonstrates a misunderstanding of the facts by the Panel. CPA's proof of claim, as well the false evidence proffered by CPA to support its assignment theory, demonstrates that the proof of claim itself was the alternative fall-back position to protect CPA from the possibility New Valley prevailed in establishing the truth. *See* App. B at 31a ("Although the Bridgeton, Missouri and Reno, Nevada leases were assigned to and assumed by Western Union Financial Services, Inc. ("FSI"), a non-debtor subsidiary of the Debtor, because the Debtor has taken the position in this bankruptcy case that the two leases were not assigned, CPA:2 and CPA:3 have included these amounts in its Proof of Claim as a precautionary measure."). The Panel's conclusion that CPA was "merely" reserving its rights to assert a "differing

(Cont'd)
Because New Valley never requested or transmitted a Proposed Consent to assignment with respect to the Moorestown Lease, CPA was unable to assert its fraudulent theory with respect to Moorestown. Nonetheless, New Valley does not believe it is improper to bar all of CPA's similar claims when it had behaved so fraudulently and deceitfully with respect to some of them. However, the fact that CPA did not manufacture evidence of an assignment of the Moorestown lease most certainly does not cleanse CPA of its other wrongdoings but at most may have some bearing upon the proper *extent* of the remedy.

interpretation" demonstrates that the Panel misunderstood the issue: it is not CPA's inconsistent reservation of supposed rights against New Valley that bars its claims, but that CPA dedicated its efforts to perpetrating a fraud in the first instance, holding the truth in abeyance as a "precautionary measure" in case its fraud failed.

CPA's misconduct clearly was "related to" the relief CPA sought. The relief CPA sought was a finding that FSI, New Valley's subsidiary, was liable to it for damages under the Leases; CPA asserted that the proofs of claim were filed against New Valley in the event that CPA was unsuccessful in establishing FSI's liability. To get that relief, CPA filed fraudulent proofs of claim with the Bankruptcy Court that misrepresented that FSI was the true liable party, and manufactured evidence — the backdated Proposed Consents — to support the claim. The essential and direct relationship is clear if the Court considers the consequences that would have resulted if CPA had accomplished its fraud: the claims upon which CPA now seeks to recover could not have been filed against New Valley because CPA's fraud would have produced a determination that New Valley was *not* the tenant under the Leases. Because successful accomplishment of the fraudulent scheme would have been outcome determinative and preclusive as to the claims CPA asserts against New Valley, CPA's fraud was necessarily closely related to and determinative of the equities and claims between the parties.

In contrast, the resulting precedent established by the Panel's decision requires, in actuality, nothing short of a finding that the existence of the cause of action must be the fruit of the fraud. This result conflicts directly with the Supreme Court's decision in *Precision Instrument Mfg. Co. v. Automotive Maintenance Machinery Co.*, 324 U.S. 806 (1945), which

explicitly held that the cause of action need not have been the fruit of the misconduct.

In *Precision Instrument*, the plaintiff sued the defendant for breach of contract and patent infringement. The contract and one of the patents resulted from a settlement of a prior dispute between the parties concerning the defendant's fraud and perjury in connection with a patent application. The plaintiff did not report the defendant's fraud to the Patent Office or the District Attorney, choosing instead to settle the dispute and acquire the rights to the patent. On appeal, the Supreme Court held that plaintiff's failure to report the defendant's fraud and perjury to the authorities required the court to invoke the unclean hands doctrine to bar the plaintiff's claims, despite the fact that plaintiff's misconduct was not the substance of its claims against the defendant. *Precision Instrument* at 816-819. *See also Manhattan Medicine Co. v. Wood*, 108 U.S. 218 (1883) (unclean hands barred plaintiff's trademark infringement claim where plaintiff made false statements to the public concerning the product, even though the misconduct had no bearing on its claims against the defendant).

In the instant case, the relationship is far more proximate. As explained above, CPA's success or failure in carrying out its fraudulent attempt to portray FSI as the tenant would have been directly determinative of whether it would have any ability to subsequently assert that New Valley is the tenant liable for breach of the Leases. A successful fraud would have precluded assertion of the same claims directly against New Valley.

Additionally, the Panel appears to have overlooked that, as the wholly owned subsidiary and primary asset of New Valley, any pecuniary injury to FSI causes equal economic

injury to New Valley by diminishing the net value of New Valley's primary asset, FSI. Thus, CPA's attempted to assert uncapped claims against FSI would have caused greater damage to New Valley than if it had asserted its statutorily capped claim directly against New Valley. *The fraud against FSI was thus equally a fraud upon New Valley.* The Panel appears to have overlooked this point in concluding that there was no sufficient relationship between CPA's claims against New Valley and its earlier fraudulent conduct. In so erring, the Third Circuit has effectively overruled *Keystone* and *Precision.*

For these reasons, New Valley urges that a writ of certiorari is necessary to correct the Panel's decision to the extent it is inconsistent with *Keystone* and *Precision Instrument* and/or to the extent the Panel's decision resulted from a clearly erroneous apprehension of the proximate relationship between CPA's attempted fraud on New Valley through FSI, and its subsequent direct claims against New Valley.

II.

A WRIT OF CERTIORARI SHOULD BE ISSUED BECAUSE THE PANEL'S DECISION, IF LEFT TO STAND, CREATES PRECEDENT THAT A PARTY MAY, WITH IMPUNITY, ATTEMPT TO DEFRAUD ITS ADVERSARY AND THE TRIAL COURT SO LONG AS IT ABANDONS THAT ATTEMPT ONCE CAUGHT.

New Valley also urges that a writ of certiorari should issue because this action will otherwise set a socially destructive precedent. It is uncontested that the Bankruptcy Court found, and the District Court observed, that CPA had

attempted to perpetrate a fraud on the court by, among other things, manufacturing and utilizing false evidence, and propounding a "theory" it knew to be false. *See supra*. It is also clear from the record that the fraud was perpetrated for the purpose of obtaining millions of dollars of damages which are barred by applicable bankruptcy law. Yet, the Panel's decision fully excused CPA's conduct. In effect, the Panel has ruled that parties, despite oaths under penalty of perjury, may try to deceive courts and manufacture evidence to support the deception provided that the deception is abandoned after discovery by the Court.[4] Despite its egregious behavior, CPA goes unpunished under the Panel's decision, whereas the targeted victim, New Valley, was forced to spend nearly $1 million to uncover and demonstrate CPA's fraud upon the Bankruptcy Court, and put at risk of losing millions more if it had failed to do so.

Generally speaking, the importance of an issue is a reason for this Court to grant review. *See, e.g., Burson v. Freeman*, 504 U.S. 191, 194 (1992) ("Because of the importance of the issue, we granted certiorari."). There can be few questions of more important and or more pervasive effect than those which threaten to undermine public confidence in and respect for the legal system. *In re Abrams*, 521 F.2d 1094 (3d Cir), *cert. denied,* 423 U.S. 1038 (1975) (maintenance of public confidence in our legal system and the bar is an important policy); *In re Quakertown Glass Co.*, 73 B.R. 468, 470 (Bankr. E.D. Pa. 1987) ("the courts and the Bar are responsible for maintaining public confidence in the legal system"). *See also, In re Levander,* 180 F.3d 1114, 1118 (3d Cir. 1999) (courts' historic power to set aside or amend fraudulently begotten judgments arises from the

4. CPA continued in its fraud long after it had been discovered by New Valley.

principal that tampering with the administration of justice in this manner involves far more than an injury to a single litigation. It is a wrong against the institutions set up to protect and safeguard the public.").

The unclean hands doctrine is an important hedge around the integrity of the legal system, and hence the public welfare,[5] because

> [p]ublic policy not only makes it obligatory for courts to deny a plaintiff relief once his 'unclean hands' are established but to refuse to even hear a case under such circumstances.

Gaudiosi v. Franklin, 269 F.2d 873, 882 (3d Cir. 1959).

The Panel's decision unfortunately states in certain terms that a multi-million dollar fraud effort that entailed, among other things, fabrication of evidence, is not the sort of inequitable and deceptive conduct that the courts should penalize. Public policy, however, required the court to close its doors to CPA after CPA conducted itself before the court in a manner so shocking to the sensibilities. *See Art Metal Works v. Abraham & Straus*, 70 F.2d 641, 646 (2d Cir. 1934) (Learned Hand dissent) ("The doctrine [of unclean hands] is confessedly derived from the unwillingness of a court, originally and still nominally one of conscience, to give its peculiar relief to a suitor who in the very controversy has so conducted himself as to shock the moral sensibilities of the judge.").

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5. *See, e.g., Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 246 (1944) ("The public welfare demands that the agencies of public justice be not so impotent that they must always be mute and helpless victims of deception and fraud.")

A writ of certiorari is therefore appropriate and necessary in this case, because allowing the Panel's decision to stand would create a rule, at least in the Third Circuit, that a party seeking money from a bankruptcy debtor need not conduct itself in accordance with fundamental ethical standards or black letter law, transfiguring the distinction between truth and lie into a mere abstraction. Accordingly, New Valley submits that the Panel's conclusions should be reviewed by this Court.

CONCLUSION

CPA's fraudulent and dishonest conduct — fabricating false evidence and perpetrating a fraud upon the court in a failed effort to circumvent unfavorable bankruptcy law by asserting claims for breach of certain leases against debtor New Valley's wholly owned non-debtor subsidiary instead of New Valley — is sufficient to bar CPA's claims under the unclean hands doctrine under the *Keystone* rule. Instead, of barring the claims, the Panel employed a novel rule of law whereby the subject claim must constitute the fraudulent conduct. This is inconsistent with the Supreme Court's rule in *Precision Instrument* that the fraud must *concern* the claim, not *constitute* the claim. Because New Valley would have been a derivative victim of CPA's scheme because it attempted to injure New Valley by devaluing its wholly owned subsidiary (and sole asset) with millions of dollars of false claims, CPA's conduct concerned its claims for relief against New Valley.

Additionally, the Panel's Opinion effectuates an incorrect public policy decision of exceptional consequence. CPA propounded a blatantly fraudulent position in order to injure New Valley by extracting more money than it was

legally entitled to from New Valley's sole asset. After getting caught and thus having no remaining option but to abandon the fraud, CPA adopted a directly inconsistent position with regard to its claims to see what it could salvage by resort to the truth. The Panel's decision to permit CPA to remain in court under these circumstances creates a rule that condones and rewards dishonest litigants who abandon a fraud upon the court and upon their adversary for no other reason than necessity after getting caught undermines the entire moral paradigm of our judicial system. New Valley's Petition for a Writ of Certiorari should be granted to prevent the constructive reversal of this Court's precedent in *Keystone* and *Precision Instrument*, and to safeguard the efficacy of the unclean hands doctrine in discouraging litigants from defrauding their adversaries and the courts.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION AND JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DATED AND FILED JULY 6, 1999

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 98-6267

IN RE: NEW VALLEY CORPORATION,

Debtor

NEW VALLEY CORPORATION,
c/o BROOKE GROUP LTD.

v.

CORPORATE PROPERTY ASSOCIATES 2 AND 3,
c/o W.P. CAREY & COMPANY, INC.

Corporate Property Associates 2 and 3,

Appellants

On Appeal from the United States District Court
for the District of New Jersey
(D.C. No. 98-cv-00982)
District Judge: Honorable Alfred M. Wolin

Argued Friday, May 21, 1999

Appendix A

BEFORE: McKEE, RENDELL and GARTH,
Circuit Judges

(Opinion filed July 6, 1999)

* * *

OPINION OF THE COURT

GARTH, *Circuit Judge*:

This appeal presents us with the question of whether the doctrine of unclean hands can be applied to deny relief to a landlord-creditor when the Bankruptcy Court has held the landlord-creditor's Proofs of Claim were not related to the events giving rise to the assertion of unclean hands.

In this case, the Bankruptcy Court held that the alleged "unclean hands" did not bar the claims for relief sought by the landlord-creditor, Corporate Property Associates ("CPA"). The District Court for the District of New Jersey reversed that determination and denied all relief to CPA.

We agree with the Bankruptcy Court that the challenged actions taken by CPA did not relate to the matters for which CPA sought payments under its leases, and that the Proofs of Claim filed by CPA did no more than reserve CPA's rights, which were controverted by the lessee, New Valley Corporation ("New Valley"). Accordingly, we will reverse the district court's Order dated July 13, 1998, denying relief to CPA, and remand to the district court so that it may resolve the remaining issues raised by the parties in their respective appeals to the district court.

Appendix A

I.

The district court had appellate jurisdiction over the final order of the Bankruptcy Court, dated January 26, 1998 which followed from its opinion of December 23, 1997, pursuant to 28 U.S.C. § 158(a).

This Court has jurisdiction under 28 U.S.C. § 158(d) and 28 U.S.C. § 1291 over the final order of the district court, dated July 13, 1998, which dismissed the claims of CPA against New Valley. CPA filed a timely Notice of Appeal on August 11, 1998.

II.

In November, 1981, CPA[1] purchased properties in Reno, Nevada; Moorestown, New Jersey and Bridgeton, Missouri, from the Western Union Realty Corporation. The Western Union Telegraph Company had been the tenant of the properties, which had been owned by Western Union Realty Corporation.

In December 1981, Western Union Telegraph Company changed its name to Western Union Corporation ("WUC"). WUC continued to be the tenant of record of the properties. In August, 1989, Western Union Financial Services, Inc. (formerly a division of WUC) ("FSI") was spun off as a wholly-owned corporate subsidiary. Two years later, in April, 1991, WUC changed its name to New Valley Corporation.

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1. There are actually two entities involved as appellees, CPA 2 and CPA 3, which will be referred to collectively as "CPA."

Appendix A

On March 15, 1990, Donald Wasson, Director of Real Estate Operations for New Valley,[2] faxed proposed "Consent to Assignment" forms (the "Consents") to Barclay Jones, then Vice President of CPA.[3] The cover letter to the proposed consent forms stated that as a result of Western Union's corporate restructuring, New Valley wished "to assign its lease[s]" to FSI for the Bridgeton and Reno properties. The proposed Consents concerned only the Bridgeton and Reno properties. No attempt was made by New Valley to assign the Moorestown, New Jersey lease. New Valley asked that CPA execute the Consents.

CPA took no immediate action on the two proposed Consents. About a month later, however, Wasson and Jones had a telephone conversation in which Jones stated that CPA would not agree to any assignments unless the Moorestown lease was also assigned by New Valley to FSI. Wasson replied that New Valley did not want to assign the Moorestown lease, as a decision had already been made by New Valley to abandon Moorestown. FSI had already been operating out of the Bridgeton and Reno properties, whereas New Valley had already moved much of its operation out of Moorestown. Wasson confirmed his impression that CPA had not agreed to the assignment of the Bridgeton and Reno

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2. Although, as indicated, WUC did not change its name until April 1991, "New Valley" will be used throughout in the interest of clarity.

3. CPA's brief identifies Jones as Vice President of CPA's "general partner." Because no further identification of CPA's general partner appears in the record, we refer to Jones as CPA's Vice President.

leases in an internal April 12, 1990 memorandum. Jones testified at trial that there had been no meeting of the minds with regard to the assignments of the leases.

No discussions were held between the parties on the issue of the assignments until May, 1993. On May 18, 1993, CPA faxed to New Valley what were purported to be executed "Consent to Assignment" forms for the Bridgeton and Reno leases. New Valley was already in bankruptcy by that date. In a letter from New Valley to CPA's counsel, dated September 8, 1993, New Valley stated that it "flatly dispute[d]" CPA's execution of the proposed Consents. New Valley had no record of the fully executed "Consent to Assignment" forms in its files. CPA responded with a letter on September 30, 1993, stating that New Valley's position reflected only a "creative bankruptcy solution" that was intended to shield FSI from liability.

On October 4, 1993, John C. Walters, a Senior Vice President of New Valley, sent a letter to CPA in order to clarify the situation involving the Bridgeton and Reno leases. The letter stated that "[w]hile FSI admittedly has operated out of the Bridgeton and Reno sites since it became operational in 1990, it has done so pursuant to an agreement with New Valley . . . which obligates FSI to reimburse New Valley for its pro rata share of the expenses. . . ." Walters noted that New Valley had wanted to assign the leases to FSI in 1990, but that it believed it could not do so without CPA's approval.

The Consents that were forwarded by CPA on May 18, 1993, had been signed on behalf of CPA by Jones, but they were dated April 15, 1990. Jones was named as "Executive

Vice President," a title that he in fact did not attain until approximately a year after the purported execution date. The date the Consents were executed, April 15, 1990, also happened to be the date of Easter Sunday. New Valley at trial presented evidence that the Consents could not have been executed on April 15, 1990, and the Bankruptcy Court credited this evidence. At trial, Jones testified that although he recalled signing the Consents, he could not recall whether he signed them on Easter Sunday, 1990.

In addition, there was evidence that, even after the purported date of the assignments (April 15, 1990), CPA was aware that New Valley in fact remained the tenant of Bridgeton and Reno. For example, Jones testified that, in September 1991, CPA sent a letter to New Valley announcing a rent increase. Further, CPA accountants requested information from New Valley in December 1991 and again in December 1994 relating to the tenancy of Bridgeton and Reno.

III.

The instant litigation commenced on November 15, 1991, when an involuntary Chapter 11 petition was filed against New Valley. New Valley consented to an entry of an order for relief under Chapter 11 on March 30, 1993.

In April, 1993, New Valley moved before the Bankruptcy Court to reject the Moorestown lease. At about the same time, New Valley moved to extend the deadline to assess whether to reject the leases for Bridgeton and Reno. On May 24, 1993, the Bankruptcy Court approved the rejection of the Moorestown lease. Although initially CPA

objected to the extension of the deadline sought by New Valley, it withdrew its objection because, it alleged, these leases [Bridgeton and Reno] may have been assigned to FSI.

As earlier mentioned, on May 18, 1993, in support of its argument that the Bridgeton and Reno leases had been assigned to FSI, CPA faxed copies of what were purported to be fully executed "Consent to Assignment" forms for those leases. On September 8, 1993, New Valley wrote to CPA and stated that it was New Valley's understanding that the leases had *not* been assigned. In its September 30, 1993 letter, CPA implied that whether the leases had been assigned informally or *de facto* was a question best resolved through litigation.

Also on September 30, 1993, CPA filed its first Proof of Claim with the Bankruptcy Court. With respect to the Bridgeton and Reno leases, CPA contended that

> [a]lthough the [Bridgeton and Reno] leases were assigned and assumed by [FSI], a non-debtor subsidiary of [New Valley], because [New Valley] has taken the position in this bankruptcy case that the two leases were not assigned, [CPA] ha[s] included these amounts in its Proof of Claim as a precautionary measure. [CPA] hereby reserve[s] the right to argue that the Bridgeton and Reno leases were in fact assigned to and assumed by FSI.

CPA included an almost identical reservation of rights in its second Proof of Claim, which was filed on January 20, 1995.

This second Proof of Claim was concerned only with Reno, and was evidently filed to reflect additional information. The Bankruptcy Court approved New Valley's rejection of the Reno lease in December 1994.

After extensive discovery and briefing, the Bankruptcy Court resolved some rental issues in an order dated October 29, 1996, on the parties' cross-motions for summary judgment on New Valley's objections to the Proofs of Claim. Those matters not resolved on motions proceeded to trial on issues relating only to the Reno and Moorestown properties. CPA's claims concerning Bridgeton had been settled before trial, and CPA's claims regarding Bridgeton were withdrawn with prejudice in June, 1997.

The trial, which was held in July, 1997, took eight days to complete. The Bankruptcy Court determined that CPA's statements in its Proofs of Claim — and its similar statements in January 1996 in a response to New Valley's Request for Admissions and Interrogatories — did not constitute admissions by CPA of its belief that the leases had been assigned. Rather, the Bankruptcy Court held that CPA did not have sufficient information to determine whether the leases had been assigned or not.

On December 23, 1997, the Bankruptcy Court issued an opinion in favor of CPA. The Bankruptcy Court, after deducting certain amounts from CPA's claims, awarded CPA a total of $2,888,469.30 in unpaid rent and other costs.[4]

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4. CPA had claimed a total due from New Valley of $3,499,084.84.

Approximately $824,000.00 of this amount was attributable to the Reno lease, and the remainder ($2,056,469.30) was attributable to the Moorestown lease.[5]

The Bankruptcy Court explicitly found that CPA's conduct regarding the assignments of the Bridgeton and Reno leases did not merit disallowance of its claims. Although the Bankruptcy Court was "wholly unconvinced" that CPA actually believed that the Bridgeton and Reno leases had been assigned, nevertheless it found "no impact on the proofs of claim . . . since the alleged assignments did not bear on any element of the proof[s] of claim. Without more, they are not sufficient circumstantial evidence that CPA concocted an inflated claim. Rather, it appears to have been a somewhat misguided effort to preserve a right against FSI in the event CPA was unlikely to be paid in the New Valley case."[6] Further, the Bankruptcy Court agreed with New Valley that it was "likely that the Consents were backdated and then produced to avoid the prospect of being limited to a lease rejection claim in the New Valley bankruptcy."[7]

The Bankruptcy Court concluded that CPA's conduct with regard to a claim against FSI arising out of the alleged

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5. We note that these figures, employed by CPA in its brief, add up to $2,880,469.30, while the Bankruptcy Court, as noted in text, awarded CPA a total of $2,888,469.30. This discrepancy is not explained by the parties. The discrepancy, however, does not affect our disposition of this appeal.

6. Bankruptcy Court Op. at 41.

7. *Id.* at 25.

assignments, was not dispositive of its claims against New Valley. "If the court had before it an objection by FSI to a CPA claim the issues surrounding execution of the Consents would be directly pertinent." However, as the claims at issue were against *New Valley*, and not *FSI*, CPA's conduct did not warrant having its claims disallowed.

Both parties appealed to the District Court for the District of New Jersey. While both raised a number of issues, the district court ruled only on the issue of unclean hands, raised by New Valley. The other issues, it decided, were rendered moot by its decision.[8]

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8. In addition to the issue of unclean hands, New Valley appealed the Bankruptcy Court's evidentiary ruling regarding CPA's alleged admissions, and its ruling that CPA's claim for rent for the Moorestown property was not subject to 11 U.S.C. § 502(b)(6)'s mandatory cap.

CPA appealed 1) the ruling of the Bankruptcy Court that its deferred maintenance costs were capped under section 502(b)(6); 2) the calculation of the section 502(b)(6) cap; 3) the determination of the reasonable rental rate for Moorestown; 4) the exclusion of CPA's claim for the cost of retaining maintenance; and 5) the Bankruptcy Court's determination of the effective rejection date for the Moorestown lease.

Because the district court held that all of CPA's claims were barred by CPA's "unclean hands," it did not reach or decide the appeals taken with regard to the other issues decided by the Bankruptcy Court. We have no occasion to address those issues either, as the only question before us is whether the district court erred in holding that CPA's unclean hands barred it from relief.

Appendix A

The district court reversed the Bankruptcy Court's determination on the grounds that the Bankruptcy Court had "abused its discretion . . . because [it] applied the wrong legal principle." The district court did not dispute that the Bankruptcy Court did in fact have discretion to refuse to apply the unclean hands doctrine.

Specifically, the district court, relying upon *Gaudiosi v. Mellon*, 269 F.2d 873 (3d Cir.), *cert. denied*, 361 U.S. 902 (1959), concluded that the Bankruptcy Court, by failing to apply the unclean hands doctrine, did not follow the law of this Circuit. Rather, the district court concluded that the doctrine of unclean hands should be applied to protect the integrity of the court itself, regardless of whether the unclean hands of a creditor injured a party and regardless of the presence of any immediate and necessary relationship between the claims before the court and the events giving rise to the assertion of unclean hands. The district court then held that CPA's conduct involving the Consents amounted to unclean hands and therefore it disallowed CPA's claims.

The district court did not hold that the Bankruptcy Court's findings of fact were clearly erroneous. However, while crediting the Bankruptcy Court's findings of fact, the district court concluded that CPA had fabricated evidence (*i.e.*, the executed Consents) and had advocated before the Bankruptcy Court a theory of assignment that it knew not to be true. The district court also questioned the testimony that Jones gave before the Bankruptcy Court. Predicated on its own analysis, and drawing upon selected findings made by the Bankruptcy Court, the district court then concluded, contrary to the conclusion reached by the Bankruptcy Court,

that CPA's conduct did have an immediate and necessary relationship with CPA's claims against New Valley.

The district court closed its opinion with the observation that "this Court must hold corporations responsible for their misconceived and improper conduct. Corporate ethics, professionalism, and verity are not lost on this Court, and when corporations denigrate these values through lack of candor . . . this Court will not countenance this type of conduct . . . [and will cause it] to apply the appropriate punishment." The district court's "appropriate punishment" here consisted of barring all relief to CPA, thereby denying CPA the $2,888,469.30 which the Bankruptcy Court had determined was due from New Valley.

This appeal followed.

IV.

In bankruptcy proceedings, we have determined that an abuse of discretion exists when "the [trial] court's decisions rests upon a clearly erroneous finding of fact, an errant conclusion of law, or an improper application of law to fact." *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 470 (3d Cir. 1998) (citations omitted). Here, as the district court did not question the Bankruptcy Court's findings of fact, it concluded that the Bankruptcy Court had abused its discretion in not applying the unclean hands doctrine on the basis of an incorrect conclusion of law.

This court reviews findings of fact by the Bankruptcy Court under a clearly erroneous standard, and its conclusions

of law under a plenary standard. *In re Visual Indus., Inc.*, 57 F.3d 321 (3d Cir. 1995). Because the district court sits as an appellate court in bankruptcy cases, our review of the district court's decision is plenary. *Id.* at 324. *See also Fellheimer, Eichen & Braverman, P.C. v. Charter Technologies, Inc.*, 57 F.3d 1215, 1223 (3d Cir. 1995).

CPA frames the issue as whether the Bankruptcy Court, "which presided over the lengthy proceedings and trial in this matter, abused its discretion in declining to apply" unclean hands. CPA referred us to *Castle v. Cohen*, 676 F. Supp. 620 (E.D. Pa. 1987), *aff'd in part and remanded on other grounds*, 840 F.2d 173 (3d Cir. 1988),[9] which had declined to apply the unclean hands doctrine to trustees of an employee stock ownership plan. In doing so, CPA identified five elements that must be present to warrant application of unclean hands against a party. CPA argued that the doctrine is applicable when: 1) a party seeking equitable relief; 2) is guilty of conduct involving fraud, deceit, unconscionability, or bad faith; 3) directly related to the matter in issue; 4) that injures the other party; and 5) affects the balance of equities between the litigants. CPA claims that essential elements of the unclean hands doctrine are lacking in the instant case.

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9. This court, affirming the *Castle* district court on this issue, held that the district court had not abused its discretion in rejecting a claim that the trustees had "unclean hands." We recited that under our "limited scope of review on this issue [unclean hands], we cannot conclude after reviewing the record [in *Castle v. Cohen*] that the district court's finding on this point is clearly erroneous." *Castle*, 840 F.2d at 178.

In particular, CPA argued that there was no direct relationship between its conduct regarding the "Consent to Assignment" forms and its Proofs of Claim. CPA reinforces its argument by referring to the Supreme Court's "clean hands" analysis in *Keystone Driller Co. v. General Excavating Co.*, 290 U.S. 240 (1933), which, among other elements, requires that there be an "immediate and necessary relationship" between the conduct and the matters in litigation. The Supreme Court stated:

> [C]ourts of equity do not make the quality of suitors the test. They apply the maxim requiring clean hands only where some unconscionable act of one coming for relief has immediate and necessary relation to the equity that [the party] seeks in respect of the matter in litigation. They do not close their doors because of plaintiff's misconduct whatever its character, that has no relation to anything involved in this suit, but only for such violations of conscience as in some measure affect the equitable relations between the parties in respect of something brought before the court for adjudication. . . . They apply the maxim, not by way of punishment for extraneous transgressions, but upon considerations that make for the advancement of right and justice.

290 U.S. at 245. In *Keystone*, the plaintiff (Keystone) sued for patent infringement. In an earlier case, against different parties, Keystone had prevailed and its patents were declared valid. Keystone then used this first judgment to bring actions against other alleged infringers. In the second case, Keystone

sought preliminary injunctions to protect the patents. The injunctions were denied, and the case proceeded to trial.

During the course of the trial in *Keystone*, it was discovered that Keystone, in its earlier case, had concealed evidence which questioned and may have tainted the validity of the patents. Affirming the Court of Appeals, the Supreme Court held that this conduct by Keystone constituted unclean hands and barred Keystone from recovery. The Supreme Court stated that the earlier decree of validity obtained in Keystone's first case was used as the basis of Keystone's action in its subsequent case. *Keystone*, 290 U.S. at 246. The Court inferred that "from the beginning it was plaintiff's intention through suppression of . . . evidence to obtain [a] decree in [the first case] for use in subsequent infringement suits against these defendants and others." *Id.* at 247. Therefore, Keystone's misconduct had a direct relation to the relief sought, so as to bar recovery. *Id.*

Although here CPA acknowledges that the district court had determined that the Consents were "immediately and necessarily related" to the litigation before the Bankruptcy Court, it argues that the district court erred in reaching that conclusion. CPA contends that the district court's conclusion that CPA lied about the assignment "was never 'asserted' in a manner that would constitute a fraud on the Bankruptcy Court."

CPA is persuasive in arguing that the doctrine of unclean hands should not be used to strip away millions of dollars in damages for conduct that the Bankruptcy Court had found was not related to CPA's claims. Indeed, CPA argues that

unclean hands cannot be applied by way of punishment for an "extraneous transgression," *see Keystone*, 290 U.S. at 245, particularly where the "transgression" charged in this case had no relationship to the Moorestown lease.

It must be remembered that no "Consent to Assignment" form had ever been executed or was claimed by CPA to have been executed with respect to the Moorestown lease, and the Moorestown lease was responsible for more than two-thirds of the damages awarded by the Bankruptcy Court.[10] CPA goes on to argue that to sustain the decision of the district court would be to grant New Valley "something for nothing," *i.e.* possession of CPA's property for years without adequate payment. Such a result, CPA claims, is alien to principles of equity.

On the other hand, New Valley claims that the district court was correct in holding that CPA's conduct barred any recovery. Referring to our decision in *Ciba-Geigy Corp. v. Bolar Pharmaceutical Company, Inc.*, 747 F.2d 844 (3d Cir. 1984), *cert. denied*, 471 U.S. 1137 (1985), New Valley charges that for unclean hands to be applied against a party,

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10. A fair reading of the Bankruptcy Court's opinion reveals that the Bankruptcy Court was concerned only with New Valley's challenges to the amount of CPA's claims, *i.e.*, whether CPA's monetary claims arising out of the leases were inflated. As a consequence, the Bankruptcy Court did not find it necessary to decide any issue respecting the Consents to Assignment but dwelt only on the rental, maintenance, and other monetary charges that were the subject of CPA's Proofs of Claim. Hence, the Bankruptcy Court concluded, as do we, that the Consents had no relation to the merits of CPA's claim.

generally all that needs to be shown are the following: 1) an unconscionable act; 2) that affects the equitable relations between the parties; 3) concerning something brought before the court for adjudication. New Valley claims that we should focus on whether a party to a controversy has acted in such a manner as to "shock the moral sensibilities of the judge," and, citing to *Gaudiosi*, 269 F.2d at 882, contends that CPA's conduct was directly related to the claims at issue in the litigation. New Valley contends that merely because CPA abandoned its "fraudulent" claim before trial does not mean that its hands became clean after years of having advanced a theory in motion practice and discovery that both the Bankruptcy and district courts later discredited as a sham.

New Valley argued that what "CPA sought was a finding that FSI . . . was liable to it for damages under the leases; the proofs of claim were filed against New Valley in the event that CPA was unsuccessful in establishing FSI's liability."[11] New Valley charged that to obtain that relief, CPA manufactured evidence and pursued a theory it knew to be false. "Moreover, CPA's conduct posed an enormous monetary risk to New Valley because New Valley was obligated to indemnify FSI against any liability under the Reno Lease."[12]

Relying upon *Keystone*, New Valley argued before us that there is a broader standard of when conduct is "related" for purposes of unclean hands. New Valley emphasized that

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11. New Valley Br. at 30.

12. *Id.* at 31.

Appendix A

CPA backdated documents and filed fraudulent proofs of claim before the Bankruptcy Court, and contended "[i]t strains credulity to accept CPA's contention that it backdated documents and manufactured evidence to support claims that it did not believe it had placed before the court."

V.

Although the parties disputed the applicability of equitable defenses to legal claims in a bankruptcy proceeding, we are far more concerned with the critical element of the unclean hands doctrine, *i.e.*, the relationship between the challenged conduct of CPA pertaining to the Consents, and the rental and other monies sought by CPA as a result of the Reno and Moorestown leases. First and foremost, we are convinced by the Bankruptcy Court's findings and its conclusion that the Consents had no "immediate and necessary" relationship to the Proofs of Claim. The Proofs of Claims filed by CPA, by their own terms, reserved for litigation the dispute as to assignment of the leases. Inasmuch as the Bankruptcy Court's findings were not held by the district court to be clearly erroneous, nor can they be so held by us, those findings could not trigger the doctrine of unclean hands under our standard of review.

In our view, the primary principle guiding application of the unclean hands doctrine is that the alleged inequitable conduct must be connected, *i.e.*, have a relationship, to the matters before the court for resolution. We will not refuse relief to a party merely because it has engaged in misconduct which is unrelated to its claims before the court. Only when "some unconscionable act of one coming for relief has

immediate and necessary relation to the equity that" the party seeks, will the doctrine bar recovery. *Keystone*, 290 U.S. at 245. Here of course those issues involved CPA's Proofs of Claim which sought payment for monies due under New Valley's leases.

As an equitable doctrine, application of unclean hands rests within the sound discretion of the trial court. *See, e.g., Ciba-Geigy*, 747 F.2d at 855 (refusing to apply unclean hands). Moreover, neither we nor the Supreme Court has required, as argued by New Valley, that application of the unclean hands doctrine is mandatory. The precedents that we find controlling make clear that there must be a relationship between the inequitable conduct and the claims brought before the court in order for the doctrine to apply; even then, the court has discretion to limit the reach of the doctrine to only some of the claims. *See, e.g., Keystone*, 290 U.S. 240; *Ciba-Geigy*, 747 F.2d 844.

The Supreme Court in *Keystone* held that "when assessing whether to invoke the doctrine of unclean hands, courts of equity must not be bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion." 290 U.S. at 245-46. When applying the doctrine, the courts in this Circuit have generally been clear that the connection between the misconduct and the claim must be close. For example, in *Monsanto v. Rohm & Haas Co.*, 456 F.2d 592 (3d Cir.), *cert. denied*, 407 U.S. 934 (1972), this Court upheld a judgment declaring a Monsanto patent invalid and unenforceable. 456 F.2d at 594. The Court found that Monsanto had misrepresented the properties of its product (a herbicide) in order to obtain a

patent, although a claim for the same product had been rejected in an earlier patent application. *Id.* at 596-97. The claim of infringement brought by Monsanto therefore directly depended upon Monsanto's misrepresentations of Monsanto's own patent, thereby providing the essential relationship for application of the doctrine. Thus, this court, after citing to *Keystone*, *id.* at 598, found that the district court was correct in concluding Monsanto had come to court with unclean hands. *Monsanto*, 456 F.2d at 600.

Where this Court *has not* applied unclean hands, the misconduct alleged *has not* been directly related to the subject of the plaintiff's suit. In *Ciba-Geigy*, we upheld the district court's grant of a permanent injunction in favor of Ciba despite allegations that Ciba had unclean hands. The district court found that evidence that Ciba had mislabelled drugs, sold adulterated batches of drugs and violated FDA regulations was insufficient to warrant application of unclean hands, as it did not involve nor relate to the matter of Ciba's claims against Bolar. *Ciba-Geigy*, 747 F.2d at 855. *See also Northeast Women's Ctr. v. McMonagle*, 868 F.2d 1342, 1354 (3d Cir.) (reversing the district court's ruling that unclean hands had precluded Northeast from obtaining an injunction against the defendants because Northeast's alleged misconduct (violation of health regulations) had no relationship to the defendants' acts in interfering with Northeast's claims), *cert. denied*, 493 U.S. 901 (1989); *General Dev. Corp. v. Binstein*, 743 F. Supp. 1115, 1136 (D.N.J. 1990) (refusing to apply unclean hands despite evidence that General Development was a general "malefactor" because that evidence did not relate directly to the misrepresentations alleged in the complaint).

Appendix A

The two cases relied on most heavily by the parties are not to the contrary. As we have noted, *Keystone*, while holding that unclean hands precluded the plaintiff (Keystone) from the relief it sought, nevertheless requires an "immediate and necessary" relationship between the conduct and the claims at issue. In *Keystone*, that relationship was found to be present, and hence, the Supreme Court upheld application of the doctrine.

In *Gaudiosi*, this court applied the doctrine of unclean hands in a proxy contest context. Our court upheld the determination of the district court that Gaudiosi had tried to "intimidate" a set of investors by sending a letter to them in order to influence their votes. In doing so, Gaudiosi had violated SEC solicitation regulations. *Gaudiosi*, 269 F.2d at 879. While our court focussed on the integrity of the court when faced with an assertion of inequitable conduct, and while we explicitly stated that no injury needed to be shown, *id.* at 881-82, it is crystal clear from the facts of the case that Gaudiosi's misconduct — the intimidation of shareholders — was directly related to the case before the court, which concerned the validity of a corporate election.

Given these precedents and their uniform requirement of an "immediate and necessary" relationship between the challenged conduct and the claims for relief, we cannot sustain the district court's decision in this case, where that relationship is absent. The district court implicitly agreed with the Bankruptcy Court's determination that there was little connection between the Consents and CPA's claims. The district court, while emphasizing the actions of CPA in backdating the Consents to Assignment, at no time suggested

that a direct relationship ever existed between CPA's conduct and CPA's Proofs of Claim.

Rather, in its opinion, the district court stated three reasons why unclean hands should prevent the recovery of monies by CPA. First, CPA had alleged a consent to assignment theory that it knew to be untrue; second, the testimony of Jones concerning the Consents strongly indicated a "selective memory;" and third, CPA misleadingly implied that it was confused as to which entity was CPA's tenant. It did so, despite some information in CPA's possession that indicated New Valley had remained CPA's tenant.

However, none of the issues which the parties disputed and which pertained to the Moorestown property were connected with the Consents to Assignment, and it was those issues that accounted for two-thirds of CPA's claims. The Consents, as noted earlier, related only to the Bridgeton and Reno leases. Moreover, the Consents simply have no relationship to CPA's claims for monies against New Valley arising out of New Valley's tenancy of Reno. Even more so, the Consents had no direct relationship to CPA's claims concerning Bridgeton. Those claims, as we have noted, had been settled earlier. Yet, the district court's reasons focus almost exclusively on the issue of the Consents.

Nor do the Proofs of Claim support the district court's holding. Indeed, under the district court's analysis, it is difficult to imagine what different or alternative language CPA could have used in its Proofs of Claim to reserve any of its rights against New Valley. The Proofs of Claim merely

set forth the fact that CPA and New Valley had differing interpretations concerning the status of the leases. Had CPA waited until the assignment issue had been litigated, it would have been out of time in presenting its bankruptcy claims against New Valley.

We hold that the Bankruptcy Court (1) applied the correct legal standard, drawn from *Keystone* and *Gaudiosi*, which established the principle of direct relationship in the cases we have cited, and (2) was not clearly erroneous in its factfinding, when it concluded that there was no immediate and necessary relationship between New Valley's assertion of unclean hands and CPA's claims.

VI.

We will therefore reverse the Order of the district court dated July 13, 1998, and remand to the district court for further proceedings (*see, e.g.*, note 8, *supra*) consistent with this opinion.

A True Copy:
Teste:

Clerk of the United States Court of Appeals for the Third Circuit

Appendix A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 98-6267

IN RE: NEW VALLEY CORPORATION,

Debtor

NEW VALLEY CORPORATION,
c/o BROOKE GROUP LTD.

v.

CORPORATE PROPERTY ASSOCIATES 2 AND 3,
c/o W.P. CAREY & COMPANY, INC.

Corporate Property Associates 2 and 3,

Appellants

On Appeal from the United States District Court
for the District of New Jersey
(D.C. No. 98-cv-00982)
District Judge: Honorable Alfred M. Wolin

Argued Friday, May 21, 1999

Present: McKee, Rendell, and Garth, *Circuit Judges*

JUDGMENT

Appendix A

This cause came on to be heard on the record from the United States District Court for the District of New Jersey and was argued by counsel on May 21, 1999.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court dated July 13, 1998 and entered July 17, 1998, be, and the same is hereby reversed and the cause is remanded to the District Court for further proceedings consistent with this opinion. Costs taxed against appellee. All of the above in accordance with the opinion of this Court.

ATTEST:

s/ P. Douglas Sisk
Clerk

Dated: July 6, 1999

APPENDIX B — OPINION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY DATED JULY 13, 1998

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 98-982

In re

NEW VALLEY CORPORATION,

Reorganized Debtor

NEW VALLEY CORPORATION,

Appellant/Cross-Appellees,

v.

CORPORATE PROPERTY ASSOCIATES,

Appellees/Cross-Appellants.

OPINION

* * *

WOLIN, District Judge

Corporate Property Associates 2 and 3 ("CPA") filed a claim in New Valley Corporation's ("NV") bankruptcy. After years of litigation and a trial, the Bankruptcy Court

determined that CPA should recover $2,888,469.30 from NV's estate. NV raises three issues on appeal, and CPA cross-appeals on five of the Bankruptcy Court's rulings. The Court has determined that the Bankruptcy Court abused its discretion by using the wrong legal principle when it decided that CPA's improper conduct did not bar its claim. The Court has also found that the Bankruptcy Court should have denied CPA any relief because CPA entered a court of equity with unclean hands. Thus, the Court will reverse the Bankruptcy Court's decision, and will deny CPA any relief. The Court will not address the other issues raised in NV's appeal and CPA's cross-appeal because the Court's decision on the doctrine of unclean hands has rendered those issues moot. Pursuant to Rule 78 of the Federal Rules of Civil Procedure, the Court decided this case without oral arguments.

BACKGROUND

I. The Leases and Parties

In 1971 and 1972, Western Union Telegraph Company ("WU") and Western Union Realty Corporation ("WU Realty") entered into three separate leases for three properties — the Moorestown Property, the Reno Property, and the Bridgeton Property. The terms of the leases are identical except for the rent. They are triple net leases, which make the tenant completely responsible for the repair, maintenance, and upkeep of the property.

In November 1981, CPA purchased the three properties and an additional property located in Bridgeton from WU Realty, and became WU's landlord for the Moorestown,

Reno, and Bridgeton Leases. In December 1981, WU changed its name to Western Union Corporation ("WUC"), and thus, WUC became the tenant under the three leases. During this time, WUC had a wholly-owned subsidiary called Western Union Financial Services, Inc. ("FSI"). In 1989, WUC made FSI a separate corporate entity so that FSI could hold substantial portions of the assets of WUC's money transfer business. On April 18, 1991, WUC changed its name to NV, and thus, NV became the tenant under the three leases.

On March 15, 1990, Donald Wasson, Director of Real Estate Operations for WUC, sent a letter and signed, proposed consents to assignment ("Consents") to Barclay Jones, then vice president of CPA's general partner. The letter requested that CPA consent to the assignment of the Bridgeton and Reno leases from WUC to FSI. A month later, Jones told Wasson that CPA would not grant the request unless WUC also assigned the Moorestown Lease to FSI. Wasson responded that CPA's demand was unacceptable because WUC premised its request on the facts that FSI was working out of the Bridgeton and Reno Properties and that the decision had been made to abandon the Moorestown Property. Wasson then sent his colleague, Jan Wolpert, a memorandum stating that CPA would not sign the Consents without the inclusions of the Moorestown Lease. For some reason, Jones signed the Consents on April 15, 1990. Although Jones was only a vice president on the date he allegedly signed the Consents, Executive Vice President appears below his signature. He did not attain that position until either June 1990 or April 1991. NV and CPA did not discuss the Consents again until May 1993.

Appendix B

During NV's Plan of Reorganization, the Bridgeton Lease was transferred to FSI. Following that transfer, CPA signed a formal assumption of lease agreement with FSI whereby FSI assumed the liabilities under the Bridgeton Lease and absolved FSI of any liability arising before the assumption. In November 1994, NV also sold FSI to First Financial Management Corporation for $1.2 billion as part of its bankruptcy reorganization. Even though CPA ultimately withdrew its claim against NV under the Bridgeton Lease, the Court will include facts regarding the Bridgeton Lease where they help complete the story.

II. The Bankruptcy Proceedings

On November 15, 1991, pursuant to Chapter 11 of the Bankruptcy Code, an involuntary petition for bankruptcy was filed against NV. On March 30, 1993, NV consented to an entry of an order for relief under Chapter 11 of the Bankruptcy Code.

III. The Leases After the Bankruptcy

A. Moorestown Lease

On May 24, 1993, the Bankruptcy Court approved NV's rejection of the Moorestown Lease. The base rent contained in the Moorestown Lease was $10.85 per square foot. NV stopped paying rent for the Moorestown Property on July 31, 1991, and stopped paying real property taxes in May 1992.

Appendix B

B. The Bridgeton and Reno Leases

Near the end of April 1993, NV filed for an application for an extension of time to assume or reject its remaining non-residential leases, which included the Reno and Bridgeton Leases, until its plan of reorganization was confirmed. CPA filed an objection to NV's application on May 14, 1993, but withdrew the objection because it had discovered that the Bridgeton and Reno leases had been assigned from NV to FSI in 1990. CPA faxed copies of the fully executed Consents to NV. After receiving the faxes, John Walters, NV's general counsel, told Wasson to search the files to determine whether NV had ever received the fully executed Consents. Wasson informed Walters that NV had never received such Consents.

On September 8, 1993, Walters wrote CPA's counsel a letter stating that NV was of the position that the Reno and Bridgeton Leases had not been assigned, and that NV or its predecessor had always been the tenant under those Leases. CPA's counsel responded with a letter on September 30, 1993, and recounted what had occurred in 1990. First, he stated that no agreement had been reached on the Moorestown Lease. Then, he wrote that after CPA told NV that CPA would not consent to the assignments of the Reno and Bridgeton Leases unless WUC also assigned the Moorestown Lease, Wasson told Jones that WUC was assigning the two leases with or without CPA's consent. Thus, CPA's counsel stated that its record indicated that WUC assigned the two leases. He added that NV's position was a " 'creative bankruptcy tactic' [that] is completely inconsistent with the operating realities of [FSI]." He

concluded: "[W]hether it can be shown that [FSI] operated out of Moorestown, Bridgeton, and Reno as a result of an actual assignment, or by way of a de facto assignment, is the stuff that lawsuits are made of."

On September 30, 1993, CPA filed its first of two Proofs of Claim in NV's bankruptcy proceeding. Although the first Proof of Claim dealt mainly with the Moorestown Lease, CPA included a footnote regarding its position on the Reno and Bridgeton Leases:

> Although the Bridgeton, Missouri, and Reno, Nevada leases were assigned to and assumed by [FSI] a non-debtor subsidiary of the Debtor, because the Debtor has taken the position in this bankruptcy case that the two leases were not assigned, CPA[ ] . . . ha[s] included these amounts in its Proof of Claim as a precautionary measure. CPA[ ] . . . hereby reserve[s] the right to argue that the Bridgeton and Reno leases were in fact assigned to and assumed by FSI.

Thus, in the first Proof of Claim, CPA argued in the alternative: either it would pursue a claim against NV in the bankruptcy proceeding, or would seek to recover from FSI.

On October 4, 1993, Walters wrote CPA's counsel a letter clarifying FSI's occupancy of the Reno and Bridgeton Properties. Walters wrote that FSI and NV had entered into an agreement whereby FSI could operate out of the Reno and Bridgeton Properties so long as it reimbursed NV for its pro rata share of the expenses associated with the property.

Walters added that NV unsuccessfully attempted to assign the two leases in 1990, and that it could not have assigned the leases without CPA's consent.

In late December 1994, NV rejected the Reno Lease. On January 20, 1995, CPA filed its second Proof of Claim. Once again, CPA included a footnote in the Proof of Claim to reserve its right to argue that the Reno Lease had been assigned to FSI:

> Although the lease was assigned to and assumed by [FSI], a non-debtor subsidiary of the Debtor which was sold to First Financial Management Corporation on October 6, 1994, CPA[ ] . . . ha[s] filed this Proof of Claim as a precautionary measure because the Debtor has taken a position that the lease was not assigned and, therefore, rejected the lease. CPA[ ] . . . hereby reserve[s] the right to argue that the Reno Lease was, in fact, assigned to and assumed by FSI.

C. CPA's Pursuit of the Assignment Theory

The Court finds it difficult to believe that after arduous pre-trial discovery and a thorough trial, the parties vigorously disagree on how long CPA pursued the theory that NV assigned the Reno and Bridgeton Leases to FSI. NV asserts that CPA pursued the theory until the time of trial. CPA argues that it abandoned the theory in June 1996, one year before the trial. Although CPA pursued the theory during the early part of the litigation, the facts support CPA's argument.

Appendix B

In March 1995, CPA filed its Response to Objections of NV to Proofs of Claim and Motions to Expunge, Disallow and Reduce Claims ("Response to Objections"). Paragraph 16 provided: "At almost every stage throughout this bankruptcy case, [CPA] ha[s] asserted that the Bridgeton Lease and the Reno Lease were previously assigned to FSI and that such leases were not property of [NV]'s bankruptcy estate." Paragraphs 19 and 31 elaborated on CPA's statement in Paragraph 16. Paragraph 19 discussed CPA's lack of discovery: "Some of the factual allegations contained in this response are based upon information available to [CPA]. To the extent that the allegations are based upon information within the possession of [NV] or FSI, discovery is needed in order to bring further light to this complicated set of facts." In Paragraph 31, CPA asserted that it was not relinquishing the contention that NV was the lessee of the Reno and Bridgeton Leases: "To the extent that this Court should find that the Reno Lease was property of [NV]'s estate, this Court should allow the amount asserted, $2,317,497.00, in full as it is based upon rent due under the Reno Lease with the 502(b)(6) cap applied to such amount."

When CPA filed its Response to Objection in March 1995, it was not heavily involved in the pursuit of its claims or in NV's bankruptcy proceeding. In fact, as of March 1995, CPA had only responded to NV's motion to extend time to decide whether to reject or assume the leases, filed the Proofs of Claim, and filed its Response to Objections.

On January 12, 1996, CPA filed its Response to NV's Request for Admissions and Interrogatories ("Request for Admissions"). In Paragraph 2, CPA denied that NV had not

assigned the Reno Lease to FSI. However, CPA also cross-referenced its response to Interrogatory 2, which provided:

> If CPA denies Request No. 2 of the Admissions Request, state the following:
>
> (a) when the assignment occurred;
>
> RESPONSE: CPA has made reasonable inquiry and the information known or readily obtainable by CPA is insufficient to be able to admit or deny the admission or respond to this Interrogatory. Response to this Interrogatory may rely on documents which cannot be fully identified by CPA because such documents have not yet been delivered to CPA in response to their Requests for Production of Documents.
>
> (b) list all documents that support such denial; and
>
> RESPONSE: Reno Consent. Additionally, *see* response to 2(a) above.
>
> (c) produce copies of all such documents, to the extent not previously produced to [NV].
>
> RESPONSE: A copy (and the original) of the Reno Consent has been produced. CPA cannot produce all documents that support

> such denial because responsive documents may be in the possession of [NV] or FSI and such documents have not yet been delivered to CPA in response to their Requests for Production of Documents. Additionally, *see* response to 2(a) above.

After receiving discovery on the assignment theory, CPA contends that it realized that no express assignment had occurred, and that it would be difficult to prove a *de facto* assignment at trial. Thus, CPA claims that it abandoned the assignment theory, and ultimately released FSI from any liability on the Reno and Bridgeton Leases in June 1996, which is more than one year before trial.

IV. Pre-Trial Proceedings Before the Bankruptcy Court

CPA's claims against NV arose out of NV's rejection of the Reno and Moorestown Leases. The claims contained three general components: (1) a claim for unpaid rent obligations ("base rent" claims); (2) a claim for unpaid obligations, i.e., utilities, maintenance, and service, which the leases obligated NV to pay, ("additional rent" claims); and (3) a claim for NV's breach of covenants in the leases requiring NV to maintain the properties in good condition ("deferred maintenance claims"). The total value of CPA's claims amounted to $3,499,084.84.

Prior to trial, both NV and CPA moved for summary judgment. On October 29, 1996, the Bankruptcy Court issued an interlocutory decision on NV's motion for partial summary judgment and CPA's cross-motion for partial

summary judgment. In denying NV's motion, the Bankruptcy Court held that CPA's Gap Claim is a separate component of CPA's claim and not subject to the statutory cap imposed by § 502(b)(6) of the Bankruptcy Code. The Bankruptcy Court also held that the rejection damages cap in the Bankruptcy Code subsumed CPA's deferred maintenance claims. Moreover, NV conceded that if the Bankruptcy Court determined that CPA should recover, then the recovery should be the full amount allowable under § 502(b)(6) of the Bankruptcy Code.

Immediately before the trial on CPA's claims, NV filed an *in limine* motion that sought to prohibit CPA from presenting any evidence regarding its claim under the Reno Lease. NV argued that CPA should be precluded from presenting any evidence on this claim because it had admitted throughout the litigation that the Reno Lease had been assigned. NV concluded that if it had assigned the lease, then CPA would have no claim against NV. In denying the motion, the Bankruptcy Court held that CPA had never made an unequivocal admission regarding the assignment, and that NV would not be prejudiced if CPA amended or withdrew the admission.

V. The Trial

The pre-trial motions, rulings, discovery, and stipulations reduced CPA's claims to two components — base rent claims and additional rent claims on both the Moorestown and Reno Properties. During the eight-day trial on NV's objections to CPA's claims, NV objected to the amounts asserted in CPA's claims and sought to disallow

the claims because of CPA's alleged misconduct. NV argued that CPA should not be allowed to recover because it had deliberately and wrongfully overstated its deferred maintenance claims for the Reno and Bridgeton Properties and because it had wrongfully asserted that the Reno and Bridgeton Leases had been assigned to FSI.

A. Maintenance Men

CPA submitted claims for the maintenance men that it employed to care for the Reno and Moorestown Properties after NV vacated them. Samantha Garbus testified that the maintenance men ensured that the properties complied with local regulations, and provided CPA with timely notice when a problem arose. CPA generally employs maintenance men to oversee vacant properties. In this situation, CPA paid its maintenance men on a regular basis. Thus, CPA thought that maintenance men were essential to its effective management of the properties.

Both leases contained the identical Article III, which deals with additional rent:

> Section 3.1. The Tenant covenants and agrees to pay, as additional rent, before any interest or additional charge may be added thereto for the non-payment thereof, all real estate taxes, special assessments, water and sewer charges and other governmental charges, general and specific, ordinary and extraordinary, unforeseen as well as foreseen, of any kind and nature whatsoever, relating to any part of the premises or facilities

> described in Section 18.1, which have been or shall become payable with respect to any portion of the term of this lease . . . .

B. Effective Date of Rejection

In April 1989, CPA learned that WUC planned to close its central telephone bureau at the Moorestown Property. WUC removed most of its equipment and furniture and closed its telephone operations by August 1989. WUC did, however, use a portion of the space for a small sales staff until October 1992. NV removed the remaining equipment in January or February 1993 at the direction of Fred Rossi, an employee of CPA. NV did not formally surrender the property to CPA until March 11, 1993.

Prior to the formal surrender, Wasson visited the property on February 23, 1993. While he was on the premises, he noticed that CPA had removed the carpet tiles, the vinyl floor tiles, and the ceiling tiles. He testified that it appeared as if CPA was preparing the property for a new tenant. Around the same time, NV stopped paying for the upkeep and maintenance of the property.

CPA began marketing the Moorestown Property before NV had formally surrendered or formally rejected the property. In fact, CPA hired Fuller Corporate Real Estate Partners ("Fuller") to market the property in 1991, and Fuller replaced NV's sign with its own in October 1991. Fuller actively marketed the property, and even asked CPA to approve an expansion of the building for a potential tenant in August 1992. Fuller rendered services for CPA until CPA hired the Mertz Corporation ("Mertz") as its exclusive agent.

Appendix B

C. Appropriate Rent for the Moorestown Lease

During the trial, NV and CPA disagreed on what rent the Bankruptcy Court should apply when determining the amount of CPA's claim for post-petition rent under the Moorestown Lease. The Moorestown Property consists of 65,000 square feet of useable space and 6,300 square feet for a mechanical penthouse.

NV produced George Powell, JR., MAI to support its position that the base rent was unreasonable. Powell has been an appraiser since 1978, received his MAI designation in 1987, teaches appraisal techniques at Rutgers University, and has testified as an expert on property valuation. After reviewing the Moorestown Property and commercial and office leasing activity from November 1991 to May 1993 in surrounding areas, he found that the office market in southern New Jersey collapsed during the relevant period. Thus, Powell declared that the fair market rent was $7.00 per square foot.

CPA contended that the base rent in the Lease, $10.85 per square foot, was reasonable because it was within the market range during the post-petition period. In trying to rebut Powell's testimony, CPA produced Maryann Franken who has worked for Mertz since 1988 as a licensed real estate broker and licensed sales associate. She is familiar with the Moorestown Property, but has never testified as an expert before this case and is not an appraiser. She stated that the market base rent for the Moorestown Property during the post-petition period was between $7.00 and $12.00 per square foot, but that the average office transaction was between

$8.00 and $10.00 per square foot. However, during her testimony, she conceded that the average deal in southern New Jersey was for 5,000 square feet, and that they "live on deals under 10,000" square feet. Although she asserted she reviewed leases for over 50,000 square feet, she was unable to specify any tenant in such a property. Finally, Franken, on behalf of CPA, attempted to lease the property for $4.50 per square foot in 1994.

D. Unclean Hands

In refuting NV's claim that it had unclean hands, CPA explained its reasons for originally asserting the assignment theory. Barclay Jones, Samantha Garbus, and Elizabeth Wagner, all of whom worked for CPA, testified that CPA was confused as to the business arrangement between FSI and NV regarding the Bridgeton and Reno Leases. FSI was the operating entity at both properties, and NV transferred valuable assets, including a number of leases, to FSI. Moreover, testimony showed that NV wanted to transfer the properties to FSI, and a document entitled the "Letter Agreement for Operating Leases" could be read as an assignment of the Bridgeton and Reno Leases.

On the other hand, NV introduced evidence to show that CPA knew that the two leases had not been assigned. For example, Walters stated that CPA never expressed any confusion regarding the tenant of the two properties. In addition, CPA's files do not contain any documents to show that FSI was the tenant under the two leases. More notably, CPA's files contained documents showing that: (1) its accountants received confirmation that NV was the tenant

as of December 31, 1991, December 31, 1992, and December 31, 1993; (2) NV gave CPA a Tenant Estoppel Certificate for the Reno Property stating that the property had not been assigned; (3) CPA sent rent increases to NV; and (4) CPA communicated to its investors that NV was the tenant of the two properties. Furthermore, Jones testified that although CPA asserted the assignment theory in the Proof of Claims, he did not know whether the statement was true or false when it was made. He also stated that he told his attorneys that the Consents "were never finalized.

In addition, Wasson, Walters, and Jones all testified that NV and CPA never consummated a deal regarding the assignment of the three leases. More importantly, NV claims that the evidence establishes that the Consents were back dated because April 15, 1990, was Easter Sunday, and because Jones did not hold the title of Executive Vice President in April 1990. Walters testified that he believed that CPA believed that it held valid Consents, and that the Consents were backdated three years because CPA wanted to avoid a situation where NV rejected the leases. Moreover, Richard Brunell, NV's handwriting expert, conducted ink identification and dryness tests to determine the date of the signature and writing below the signature. He was unable to reach a conclusion for the signature but he concluded to a high degree of scientific certainty that "Executive Vice President" was most possibly written in 1993.

Jones, however, testified that he remembers signing the documents, but could not remember the exact date. He stated that he could have signed them on Easter Sunday. He conceded that the dates and title were not his handwriting,

and Eve Berman, the former head of the property management department at W.P. Carey, testified that the title and dates were in her handwriting, but that she could not remember writing them. Berman also stated that she doubted that she wrote on the Consents in 1993, and that no one from CPA asked her to backdate the documents.

During the trial, Jones conceded that in 1993, he knew that it was better for CPA to have FSI as a tenant because it was a solvent subsidiary of NV. He also admitted that unlike a claim against NV, a claim against FSI would not be subject to a statutory cap.

NV claimed that CPA's improper conduct regarding the inflation of claims and the Consents caused it to incur legal fees in excess of $850,000. Marc Bell, NV's Associate General Counsel, testified that NV would have settled CPA's claims if CPA had not asserted the assignment theory.

Despite its assertions about CPA's improper conduct, NV did not do anything or refrain from doing anything because of the Consents. In fact, Walters testified that the Consents did not alter NV's position on the Reno and Bridgeton Leases because they were meaningless to him and he disregarded them. He also stated that the Consents were not the reason that NV and CPA were unable to settle CPA's claims early in the litigation. Furthermore, Walters testified that the Consents did not factor into the sale of FSI. Lastly, NV never spent any money indemnifying FSI because of the Consents.

Appendix B

E. Bankruptcy Court's Rulings

On December 23, 1997, the Bankruptcy Court issued an Opinion, which made the following rulings. First, the court decided that it would follow the test established in *In re McSheridan*, 184 B.R. 91 (B.A.P. 9th Cir. 1995), for determining what items should be included as additional rent under § 502(b)(6)(a). The court then held that the maintenance men that CPA employed to care for the property did not count towards the additional rent claims because they did not fall within Article III in the leases. Thus, the Bankruptcy Court reduced CPA's claims by "$10,912.50 for the maintenance man component of additional rent on the Reno Lease, [ ] $6,000.00 for the maintenance man component of the Gap Claim for additional rent on the Moorestown Lease, and [ ] $18,582.35 for the maintenance man component of rejection damages claim for additional rent on the Moorestown Lease."

Second, the court agreed with the majority rule that court approval is a condition precedent for an effective rejection of a lease under § 365(d)(3). *See, e.g., In re Thinking Machs. Corp.*, 67 F.3d 1021 (1st Cir. 1995). The court then stated that it would exercise its equitable powers in making the rejection retroactive to February 23, 1993, rather than May 24, 1993, the date the court signed the order authorizing rejection, because it found that CPA exercised complete control over the property on February 23, 1993. That finding reduced CPA's claims by $200,000.

Third, the court held that the rent in the lease, $10.85 per square foot, was unreasonable when compared to the

market, and thus, set the rent for the postpetition period at $7.00 per square foot. In reaching this holding, the court found that Franken's experience did not support her opinion as to the reasonable rate. Thus, it relied on NV's expert's opinion in declaring that the base rent in the Moorestown Lease was unreasonable.

In its fourth ruling, the Bankruptcy Court rejected NV's request that it use its equitable powers and disallow CPA's claims because CPA had unclean hands. The court first determined that CPA had not inflated its deferred maintenance claims. As for the Consents, the Bankruptcy Court found that CPA never believed that NV assigned the Bridgeton[1] and Reno Leases to FSI. "The court suspects that CPA took that position as a negotiating tactic in order to minimize any losses it might suffer as a result of the [NV] bankruptcy." The Court also agreed with Walters's belief that CPA had backdated the Consents: "[I]t is likely that the [C]onsents were backdated and then produced to avoid the prospect of being limited to a lease rejection claim in the [NV] bankruptcy." In reaching that finding, the Bankruptcy Court determined that Jones's lack of memory on when he signed his name was incredible, and that NV's expert was convincing. The Bankruptcy Court also stated that CPA's actions are understandable when one considers the dire financial situation of NV and the solvency of FSI in 1993 — FSI was a more desirable tenant. The court also did not

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1. In its Opinion, the Bankruptcy Court mistakenly stated Moorestown instead of Bridgeton. This Court has substituted Bridgeton for Moorestown because NV claims that CPA executed the Consents for the Reno and Bridgeton Leases, not the Moorestown Lease.

believe that CPA was confused as to which entity was the tenant under the two leases because Jones closely oversaw the properties and because ample documents existed to show that NV was the tenant.

After making those findings, the Bankruptcy Court held: "[T]he court perceives no impact on the proofs of claim . . . [because] the alleged assignments did not bear on any element of the proof of claim. . . . [I]t appears to have been a somewhat misguided effort to preserve a right against FSI" if the Bankruptcy Court disallowed its claim against NV. The court emphasized that NV's argument would be more persuasive if CPA's conduct had been directed at it rather than at FSI. The court then rejected NV's argument that CPA's alleged misconduct caused NV to spend money defending CPA's claim because the proceeding involved many complicated legal issues and a large claim. Ultimately, the Bankruptcy Court allowed CPA's claims in the amount of $2,888,469.30.

On January 26, 1998, the Bankruptcy Court issued an Order memorializing its Opinion. NV appeals the Bankruptcy Court's decision allowing CPA's claims. NV raises three issues in its appeal: (1) the Bankruptcy Court erred in concluding that CPA's conduct did not warrant the disallowance or reduction of CPA's claims; (2) the Bankruptcy Court erred in denying NV's objection that CPA not be allowed to introduce evidence inconsistent with its judicial admissions or regarding NV's obligations to CPA under the Reno Lease; and (3) the Bankruptcy Court incorrectly determined that CPA's claim for rent under the Moorestown Lease for the Gap Period was not subject to § 502(b)(6)'s mandatory cap.

CPA cross-appeals the Bankruptcy Court's decision. It raises five issues in its cross-appeal: (1) the Bankruptcy Court erred in determining that CPA's claims for deferred maintenance were capped pursuant to § 502(b)(6); (2) the Bankruptcy Court should have used the time remaining, and not the amount of rent remaining, under the Leases to calculate the cap under § 502(b)(6); (3) the Bankruptcy Court erred by holding that the reasonable rental rate for the Moorestown Property was $7.00 per square foot rather than the rent set forth in the lease; (4) the Bankruptcy Court mistakenly excluded CPA's claim for the cost of retaining maintenance; and (5) the Bankruptcy Court erred by ruling that the effective rejection date for the Moorestown Lease was February 25, 1993, and not May 24, 1993.

DISCUSSION

I. Relevant Legal Standards

United States District Courts have mandatory jurisdiction to hear appeals from final orders of bankruptcy judges. *See* 28 U.S.C. § 158(a)(1); Fed. R. Bankr. Pro. 8001(a). On appeal, a district court may set aside a bankruptcy court's findings of fact only if clearly erroneous. *See, e.g., In re Sharon Steel Corp.*, 871 F.2d 1217, 1222 (3d Cir. 1989); *General Elec. Credit Corp. v. Nardulli & Sons, Inc.*, 836 F.2d 184, 186 (3d Cir. 1988); *In re Brennan*, 198 B.R. 445, 448 (D.N.J. 1996). "[A] finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *Anderson v. City of Bessemer City, N.C.*, 470

U.S. 564, 573, 105 S. Ct. 1504, 1511 (1985) (quotation omitted). The fact that a reviewing court could have decided the matter differently does not render a finding of fact clearly erroneous. *See* Fed. R. Bankr. R. 8013; *Anderson*, 470 U.S. 573-74, 105 S. Ct. at 1511. In contrast, a district court reviews a bankruptcy court's legal conclusions or questions of law under a plenary or de novo standard. *See, e.g., In re Modular Structs., Inc.*, 27 F.3d 72, 76 (3d Cir. 1994) (citation omitted); *J.P. Fyfe, Inc. v. Bradco Supply Corp.*, 891 F.2d 66, 69 (3d Cir. 1989). If the questions involve both law and fact, courts should apply the appropriate standard to each component. *See In re Sharon*, 871 F.2d at 1222.

II. Doctrine of Unclean Hands

A. Standard of Review

NV and CPA hotly contest what standard the Court should use in reviewing the Bankruptcy Court's decision to not invoke the doctrine of unclean hands. NV frames the issue as whether the Bankruptcy Court properly applied the doctrine of unclean hands in deciding not to reduce or disallow the claims. NV concludes that the Court should review this issue *de novo* because the facts are not in dispute. CPA counters that the proper standard of review is abuse of discretion because the application of the doctrine of unclean hands rests within the discretion of the trial court.

Although the Third Circuit has stated that "[a] mixed question of law and fact is found whenever a legal precept is applied to the sum of the facts of a case," *Meridian Bank v. Alten*, 958 F.2d 1226, 1229 (3d Cir. 1992) (citations omitted),

a district court should reverse a bankruptcy court's application of the doctrine of unclean hands only if the district court finds that the bankruptcy court abused its discretion. *See Barry v. Hialeah Miami Springs Med. Fund*, 184 B.R. 611, 613 (S.D.Fla. 1995); *see also Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245-46, 54 S. Ct. 146, 148 (1933) (discussing standard of review of application of unclean hands in patent case); *Castle v. Cohen*, 676 F. Supp. 620, 628 (E.D.Pa. 1987) (discussing standard of review of application of unclean hands in ERISA case), *aff'd in part* and *vacated in part*, 840 F.2d 173 (3d Cir. 1988). Abuse of discretion is the correct standard because when assessing whether to invoke the doctrine of unclean hands, "[courts of equity] must not be bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion." *Keystone Driller*, 290 U.S. at 245-46, 54 S. Ct. 146, 148; *accord Barry*, 184 B.R. at 613; *Castle*, 676 F.Supp. at 628. Abuse of discretion occurs when a court fails to apply the correct legal precepts or bases its decision on clearly erroneous findings of fact. *See Meridian Bank*, 958 F.2d at 1230 n.2.

The Court notes that the determination of whether to invoke the doctrine of unclean hands is an equitable one that can best be made by the trial court. In this case, NV does not challenge the Bankruptcy Court's factual findings or statement of the law, but rather the determination that the circumstances of this case did not warrant the invocation of the doctrine of unclean hands. In essence, NV argues that the court failed to apply the law properly.

B. Analysis

NV argues that the Bankruptcy Court should have invoked the doctrine of unclean hands to reduce or disallow CPA's claims for five reasons: (1) even though CPA knew that the Reno and Bridgeton Leases had not been assigned, CPA asserted that they were assigned in order to avoid the statutory restrictions imposed by NV's bankruptcy; (2) CPA altered documents to support its assertion; (3) the Bankruptcy Court erred in finding that CPA's actions did not have an impact on this case because FSI was a wholly-owned subsidiary of NV and because NV was obligated to indemnify FSI of any liability under the Reno Lease; (4) CPA should not be rewarded for conduct that might be criminal; (5) the Bankruptcy Court should have granted NV's motion *in limine* because at the trial, CPA contradicted its pre-trial admission that NV had assigned the Reno Lease to FSI when it stated that NV was liable for the Reno Lease.

"It is one of the fundamental principles upon which equity jurisprudence is founded, that before a complainant can have a standing in court he must first show that not only has he a good and meritorious cause of action, but he must come into court with clean hands." *Keystone Driller*, 290 U.S. at 244, 54 S. Ct. at 147. However, "courts of equity . . . apply the maxim requiring clean hands only where some unconscionable act of one coming for relief has immediate and necessary relation to the equity that he seeks in respect of the matter in litigation." *Id.* at 245, 54 S. Ct. at 147-48; *accord CIBA-GEIGY Corp. v. Bolar Pharm. Co., Inc.*, 747 F.2d 844, 855 (3d Cir. 1984), *cert. denied*, 471 U.S. 1137, 105 S. Ct. 2678 (1985); *General Dev. Corp. v. Binstein*, 743

F. Supp. 1115, 1134 (D.N.J. 1990). In essence, the doctrine applies only to those acts that "in some measure affect the equitable relations between the parties in respect of something brought before the court for adjudication." *Keystone Driller*, 290 U.S. at 244, 54 S. Ct. at 148.

Although the doctrine of unclean hands can only be applied if the conduct is related to the equity being sought, defendants need not show that plaintiffs' inequitable conduct injured them. *See Gaudiosi v. Mellon*, 269 F.2d 873, 882 (3d Cir.), *cert. denied*, 361 U.S. 902, 80 S. Ct. 211 (1959). In fact, injury to the defendant is irrelevant because the doctrine of unclean hands is invoked to protect the court's integrity rather than to defend a litigant. *See id.* at 881 (citation omitted). When a party has unclean hands, courts must "den[y him] all relief whatever may have been the merits of his claim." *Id.* at 881-82 (quotation omitted).

The Court finds that the Bankruptcy Court abused its discretion in this case because the Bankruptcy Court applied the wrong legal principle when it based its decision to not invoke the doctrine of unclean hands on a "no harm, no foul" rule, i.e., the doctrine of unclean hands did not apply because the alleged assignments did not bear on the proofs of claim. As shown *supra*, the Third Circuit has rejected the "no harm, no foul" rule and adopted an approach that looks to protect courts from unscrupulous parties. Thus, this Court must determine whether CPA's conduct violated the doctrine of unclean hands as articulated *supra*.

The Court will adopt the Bankruptcy Court's findings of fact because neither party disputes or contests those

findings. The relevant findings of fact are that: (1) CPA never believed that NV assigned the Bridgeton and Reno Leases, but took that position in an attempt to minimize its losses in NV's bankruptcy; (2) Jones testified that he told his attorneys that the Consents were never finalized; (3) NV's handwriting expert was convincing, and Jones's lack of memory on when he signed the Consents was incredible; (4) CPA likely backdated the Consents because it wanted to avoid a limited recovery in NV's bankruptcy; (5) CPA was not confused as to who the tenant was under the two leases because Jones closely oversaw the properties and because CPA's internal documents clearly showed that NV was the tenant.

Legal precedent dictates that this Court invoke the doctrine of unclean hands because the Bankruptcy Court's findings of fact clearly show that CPA's improper conduct was "immediately and necessarily" related to the equity CPA sought before the Bankruptcy Court and definitely affected "the equitable relations between the parties." Fabricating or altering evidence is certainly an affront to the Court that warrants the application of the doctrine of unclean hands. *See Mas v. Coca-Cola Co.*, 163 F.2d 505, 508 (4th Cir. 1947) ("It is sufficient to bar relief that plaintiff has been guilty of unconscionable conduct directly related to the cause of action, such as the fabrication of testimony, the subornation of perjury or other like attempt to perpetuate fraud upon the court or take an unconscionable advantage of his adversary."); *Aris-Isotoner Gloves, Inc. v. Berkshire Fashions, Inc.*, 792 F. Supp. 969 (S.D.N.Y.) (finding that doctrine of unclean hands had to be invoked because fabricating testimony was unconscionable), *aff'd*, 983 F.2d 1048 (2d Cir. 1992); *Grimes v. Green Point Sav. Bank*, 147

B.R. 307, 316 (Bankr. E.D.N.Y. 1992) (denying debtor's application for preliminary injunction against mortgagee because, *inter alia*, debtor "knowingly and willingly participated in deceitful conduct involving her daughter's forging the name of her sister . . . on documents."). CPA also committed a fraud on the Court by asserting a theory that it knew to be untrue. Furthermore, although the Bankruptcy Court did not make a finding that Jones committed perjury, it did find that his testimony was incredible because his direct oversight of the three properties and his position with CPA made it unlikely that he would not remember when he signed the Consents. That finding supports the application of the doctrine of unclean hands because it appears as though Jones had "selective memory" regarding CPA's fraudulent conduct. Finally, CPA also defrauded the Court when it alleged that it was confused as to which entity was the tenant under the leases. The Bankruptcy Court found that the documents in CPA's possession showed that CPA knew that NV, and not FSI, was the tenant during the years in question. Thus, the Court must invoke the doctrine of unclean hands to protect its integrity.

The Court's decision to invoke the doctrine of uncleans against CPA mandates that the Court deny CPA any relief. The Court recognizes that denying CPA $2,888,469.30 when the Bankruptcy Court found that CPA's improper conduct did not affect the outcome of this case appears to be a harsh result. However, this Court must hold corporations responsible for their misconceived and improper conduct. Corporate ethics, professionalism, and verity are not lost on this Court, and when corporations denigrate these values

through lack of candor in their pursuit of financial gains, this Court has not and will not countenance this type of conduct. Further, the Court has not and will not hesitate to apply the appropriate punishment to protect other corporations, individuals, and the integrity of this Court. Therefore, the Court will reverse the Bankruptcy Court's decision, and will deny CPA its claim because it entered a court of equity with unclean hands.

The Court will not address the other issues raised in NV's appeal or in CPA's cross-appeal because the Court's ruling on the doctrine of unclean hands renders the other issues moot.

CONCLUSION

For the reasons stated *supra*, the Court will reverse the Bankruptcy Court's decision on the issue of the doctrine of unclean hands, and will deny CPA's claim in its entirety.

An appropriate Order is attached.

Dated: July 13, 1998

s/ Alfred M. Wolin, U.S.D.J.
ALFRED M. WOLIN, U.S.D.J.

Appendix B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

Civil Action No. 98-982

In re

NEW VALLEY CORPORATION,

Reorganized Debtor

NEW VALLEY CORPORATION,

Appellant/Cross-Appellees,

v.

CORPORATE PROPERTY ASSOCIATES,

Appellees/Cross-Appellants.

ORDER

In accordance with the Court's Opinion filed herewith,

It is on this 13th day of July, 1998,

ORDERED that the Bankruptcy Court's decision dated December 23, 1997, and Order of January 26, 1998, which memorializes that Opinion, is reversed; and it is further

Appendix B

ORDERED that Corporate Property Associates' claim against New Valley Corporation's bankruptcy estate is denied.

s/ Alfred M. Wolin, U.S.D.J.
ALFRED M. WOLIN, U.S.D.J.

APPENDIX C — OPINION OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF NEW JERSEY DATED AND FILED DECEMBER 23, 1997

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW JERSEY

Case No. 91-27704 (NLW)

Chapter 11

In re

NEW VALLEY CORPORATION,

Debtor.

Before: Honorable Novalyn L. Winfield

OPINION

* * *

The court conducted an evidentiary hearing on the objections filed by New Valley Corporation to the proofs of claim submitted by Corporate Property Associates 2 and 3. The following constitutes the court's findings of fact and conclusions of law made in accordance with Federal Rule of Bankruptcy Procedure 7052. The court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and the Standing Order of Reference by the United States District Court of New Jersey, dated July 23, 1984. Moreover, the matter at hand is a core proceeding under 28 U.S.C. § 157(b)(2)(B).

Appendix C

FINDINGS OF FACT

A. General Factual Background

1. On or about September 16, 1971, Western Union Telegraph Company, New Valley's predecessor-in-interest, entered into an Indenture of Lease with Western Union Realty Corporation, relating to the real property located at 308 West Route 38, Moorestown, New Jersey ("the Moorestown Property"). This Indenture or Lease, together with all subsequent amendments, shall be known as "the Moorestown Lease." (CPA-1).

2. On or about July 12, 1972, Western Union Telegraph Company, entered into an indenture of Lease with Western Union Realty Corporation, CPA's predecessor-in-interest, relating to the real property located at 5025 Mill Street, Reno, Nevada ("the Reno Property"). This Indenture of Lease, together with all subsequent amendments, shall be known as "the Reno Lease." (CPA-4).

3. At some point in or about 1981, Western Union Realty Corporation put these Properties, as well as two other properties located in Bridgeton, Missouri, on the market. (Jones Tr. 7/9/97, 81-13 to 82-24).

4. On or about November 16, 1981, CPA acquired all four properties from Western Union Realty Corporation. (CPA-1 and CPA-4).

5. Through this transaction, CPA collectively acquired (and still owns) 100% of the Moorestown Property and the

Reno Property. (Jones Tr. 7/9/97, 65-3 to -6; Garbus Tr. 7/10/97 A.M., 42-7 to -19).

6. At the time CPA acquired them, Western Union Telegraph Company was the tenant at the Moorestown and Reno Properties. (Jones Tr. 7/9/97, 78-20 to -22).

7. In or about December 1981, Western Union Telegraph Company changed its name to Western Union Corporation ("Western Union"). Western Union continued to be the tenant on the Leases at the Moorestown and Reno Properties after the name change. (Jones Tr. 7/9/97, 75-22 to 76-2).

8. In or about August 1989, Western Union Financial Services, Inc. ("FSI") was created as a separate corporate entity. Prior to that time it had been a division of Western Union. (Tr. 7/17/97, 56-8 to 14).

9. Western Union changed its name to New Valley Corporation ("New Valley") on April 18, 1991.

10. In or about November 1994, New Valley sold FSI to First Financial Management Corp. for over $1 billion.

B. The terms of the Leases

11. When CPA acquired the Moorestown and Reno Properties in November 1981, it assumed the Leases already in place between Western Union Telegraph Company and Western Union Realty Corporation. (Jones Tr. 7/9/97, 83-25 to 84-15).

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12. With the exception of the rental rates, the terms of the Moorestown Lease and the Reno Lease are identical. (CPA-1; CPA-4).

13. If they had not be rejected by New Valley, the Moorestown Lease and the Reno Lease would have expired on November 30, 2001. (CPA-1 and CPA-4, Second Amendment to Lease Agreement).

14. Both the Moorestown Lease and the Reno Lease are triple net leases. (CPA-1 and CPA-4, Sections 6.1, 7.1, 9.1). Under a triple net lease, the tenant is completely responsible for the repair, maintenance and upkeep of the property.

15. Under both the Moorestown Lease and the Reno Lease, New Valley was responsible for paying all expenses necessary to maintain, upkeep and operate the properties, as well as all property taxes, insurance, government charges, water and sewer charges, whether foreseen or unforeseen. (Jones Tr. 7/9/97, 67-7 to -18; CPA-1, Section 6.1; CPA-4, Section 6.1).

16. At the time CPA acquired the Moorestown and Reno Properties, CPA and Western Union Telegraph Company negotiated, at arms-length, a twenty-year lease with a sliding scale of rental rates over time (CPA-1 and CPA-4, Second Amendment to Lease Agreement; (Jones Tr. 7/9/97, 86-4 to 88-6).

17. As set forth in the Second Amendment of Lease Agreement, dated November 16, 1981, the applicable rental terms of the Moorestown Lease are as follows:

(a) $699,300.00 per annum from November 16, 1981 through November 15, 1986

(b) $702,408.00 per annum from November 16, 1986 through November 15, 1991

(c) $705,516.00 per annum from November 16, 1991 through April 30, 1997

(d) $271,176.00 per annum from May 1, 1997 through March 31, 1998

(e) $449,130.00 per annum from April 1, 1998 through November 30, 2001

(CPA-1 Second Amendment of Lease Agreement)

18. As set forth in the Second Amendment of Lease Agreement, dated November 16, 1981, the applicable rental terms of the Reno Lease are as follows:

(a) $405,515.00 per annum from November 16, 1981 through November 15, 1986

(b) $452,509.00 per annum from November 16, 1986 through November 15, 1991

(c) $454,503.00 per annum from November 16, 1991 through April 30, 1997

(d) $485,178.00 per annum from May 1, 1997 through March 31, 1998

(e) $391,803.00 per annum from April 1, 1998 through November 30, 2001

(CPA-4, Second Amendment to Lease Agreement).

19. Neither Western Union nor New Valley ever complained that the rental rates set in November 1981 were unfair. (Jones Tr. 7/9/97, 88-7 to -19); Wasson Tr. 7/16/97, 107-3 to -23; Walters Tr. 7/17/97, 54-22 to 55-3).

C. The New Valley Bankruptcy

20. On November 15, 1991, an involuntary petition for bankruptcy pursuant to Chapter 11 of the Bankruptcy Code was filed against New Valley.

21. On March 30, 1993, New Valley consented to entry of an order for relief under Chapter 11 of the Bankruptcy Code.

22. On November 14, 1994, the Court entered an Order confirming the First Amended Joint Chapter 11 Plan of Reorganization of New Valley Corporation.

D. Calculation of the Base Rent and Additional Rent

23. Both New Valley and CPA agree that the base rent due under the Reno Lease is $654,327.94 and the court accepts that figure.

24. As to the Moorestown Lease, the court finds that CPA's calculation of the rent owed accurately measures the

time period which CPA may include in its Gap Claim. CPA calculated its Pre-petition Claim by calculating unpaid rent accrued prior to November 15, 1991, the date the involuntary petition was filed. It then calculated its Gap Claim as running from November 16, 1991. Contrary to New Valley's assertion, it does not appear that CPA included more than one-half of November, 1991 in each of its claims.

25. However, the court also finds that the claimed expenses for a maintenance man at the Reno property ($10,912.50) and at the Moorestown Property ($24,582.35) are not allowable as additional rent. Firstly, the terms of the respective leases do not include such an expense as an item of additional rent. The pertinent provision provides as follows:

> Section 3.1. The Tenant covenants and agrees to pay, as additional rent, before any interest or additional charge may be added thereto for the non-payment thereof, all real estate taxes, special assessments, water and sewer charges and other governmental charges, general and special, ordinary and extraordinary, unforeseen as well as foreseen, of any kind and nature whatsoever, relating to any part of the premises or facilities described in Section 18.1, which have been or shall become payable with respect to any portion of the term of this lease . . .

(CPA-1; CPA-4).

On the other hand, both leases are triple net leases and section 6.1 of both leases makes the tenant responsible for all expenses necessary to maintain, upkeep and operate the properties.

26. At trial, Samantha Garbus ("Garbus") testified that the maintenance men at Reno and Moorestown were essential as the on site "eyes and ears" of CPA. She stated that they insured compliance with local regulations regarding maintenance and their presence insured that timely notice of problems was received. Garbus noted that it can be expensive to bear the risk of fines and system failures. (Garbus Tr. 7/10/97 A.M., 31-14 to 34-9).

27. It was also established at trial that CPA made payments to both maintenance men at fixed, regular intervals, either weekly or monthly. (Garbus Tr. 7/10/97 A.M., 46-3 to -25, 49-7 to -15, 50-2 to -12). It appears to be CPA's usual practice to hire a maintenance person to oversee vacant properties. (Garbus Tr. 7/10/97 A.M., 41-11 to 44-2; Wagner Tr. 182-21 to 183-6). It was also noted that New Valley similarly utilized a maintenance man at the Moorestown Property during the time that it was partially vacant. (Wasson Tr. 7/16/97, 109-24 to 110-15, 111-7 to 112-5).

28. All of the foregoing certainly establishes CPA's belief that a maintenance person was essential to their effective management of the Reno and Moorestown property. However, it does not follow from that premise that the expense is related to the value of the property or an obligation of the tenant in the same manner as alarm/security service, for example. CPA apparently believed that the maintenance

men served an important function in insuring that various services were timely and properly performed. It is likely that other alternatives for monitoring the upkeep of the properties were available. While such services as utilities, lawn maintenance, servicing of the building systems are all items which are readily identifiable as additional rent, it is not apparent to the court that the monitoring of these items by CPA is a charge that ought to be treated as additional rent.

29. New Valley also contends that CPA made an arithmetical error in the computation of the additional rent due under the Moorestown Lease. The alleged error occurred, according to New Valley, because CPA applied the agreed upon rejection damages formula to post-rejection taxes of $275,317.38, when the post-rejection taxes are actually $229,334.77. Unfortunately, New Valley did not identify the basis for its claim of error.

30. In support of its claim for additional rent for the Moorestown Property CPA provided a schedule of property taxes as follows:

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MOORESTOWN PROPERTY TAXES

3d Quarter 1992	$ 48,168.76	
4th Quarter 1992	$ 48,168.76	pre-rejection
1st Quarter 1993	$ 45,982.62	
2d Quarter 1993	$ 45,982.61	
3d Quarter 1993	$ —	(credit)
4th Quarter 1993	$ —	(credit)
1st Quarter 1994	$ 19,172.27	(partial credit)
2d Quarter 1994	$ 22,227.50	
3d Quarter 1994	$ 23,791.50	
4th Quarter 1994	$ 23,791.50	
1st Quarter 1995	$ 23,009.50	
2d Quarter 1995	$ 23,009.50	
3d Quarter 1995	$ 23,774.50	
4th Quarter 1995	$ 23,774.50	
1st Quarter 1996	$ 23,392.00	
2d Quarter 1996	$ 23,392.00	
TOTALS:	$ 275,317.38	(post rejection)
	$ 188,302.75	(pre-rejection)

31. The court's review of the CPA schedule indicates that second quarter 1993 taxes in the amount of $45,982.61 were included by CPA in the calculation of its pre-rejection total of $188,302.75, and its post-rejection total of $275,317.38. It appears that the second quarter 1993 taxes were due and payable May 1, 1993 (CPA-9). Thus the taxes came due in the post-rejection period and are properly included in CPA's calculation of the rejection damages claim

for additional rent. It does appear, however, that the pre-rejection claim should be adjusted.

E. Effective Date for Rejection of the Moorestown Lease

32. In April, 1989 CPA learned that Western Union intended to close its central telephone bureau ("CTB") operations at the Moorestown Property. (Wasson Tr. 7/16/97, 16-10 to 17-21; NV-44; Jones Tr. 7/9/97, 89-20 to 90-17).

33. By August, 1989 Western Union had removed most of its equipment and furniture and had closed the CTB operations, (Wasson Tr. 7/16/97, 18-8 to -13).

34. However, Western Union continued to use some of the space for a small sales staff through October, 1992. (Wasson Tr. 7/16/97, 18-14 to 19-5). The remaining equipment and furniture was removed in January or February, 1993 at the request of Fred Rossi, acting on behalf of CPA. (Wasson Tr. 7/16/97, 19-6 to 20-16; CPA 17, Tab 1).

35. As reflected in a letter from Donald Wasson ("Wasson") of New Valley to Barclay Jones of CPA, the Moorestown Property was not formally surrendered until March 11, 1993. (CPA-2; NV-64).

36. Just prior to the formal surrender, on February 25, 1993 Wasson visited the Moorestown Property. At that time he observed that CPA had removed and stacked carpet tiles, and removed vinyl floor tiles, as well as ceiling tiles. (Wasson Tr. 7/16/97, 21-19 to 22-17. Wasson further testified:

> It just looked like a — I shouldn't say — well, we use the word gutting of the building, gutting in the respect to preparing the building in order to do, you know, tenant improvements later on. That's what it appeared to be.

(Wasson Tr. 7/16/97, 22-8 to -12).

37. New Valley ceased paying base rent for the Moorestown Property as of July 31, 1991. (Garbus Tr. 7/10/97 A.M., 37-11 to 38-7; NV-87 at ¶ 20). CPA reported same to its partners and the Securities and Exchange Commission in its Form 10-Q statements for the quarters ending September 30, 1992 and March 31, 1993, stating that "New Valley vacated the [Moorestown] facility in August, 1989 and continued to pay its rent in a timely manner through July, 1991." (NV-11 at 11673, 11632; 12154, 12013).

38. New Valley stopped paying real property taxes on the Moorestown Property as of May, 1992. (CPA-9; NV-61).

39. Further, in or about the end of February, 1993 New Valley stopped paying the expenses for the upkeep and maintenance of the Moorestown Property. (CPA-9).

40. Approximately one month after New Valley consented to entry of the order for relief under Chapter 11, it moved for court approval of its rejection of the Moorestown Lease. An order approving rejection of the lease was entered on May 24, 1993. (NV-81 thru 83).

41. However, CPA did not wait until formal surrender or rejection to begin its marketing efforts for the Moorestown Property. CPA hired Fuller Corporate Real Estate Partners ("Fuller") to market the property, and in October, 1991 the New Valley broker's sign was removed and replaced by Fuller's. (Wasson Tr. 7/16/97, 24-14 to 26-13).

42. Fuller advertised the property, responded to offers and even sought Moorestown Township's approval in August, 1992 for expansion of the building for a potential new tenant. (Garbus Tr. 7/10/97 A.M., 95-12 to 96-8; NV-19 at 2015-17, 79, 59, 39A, 39B). Fuller continued to render services for CPA until CPA hired Mertz Corporation as its exclusive agent. (Franken Tr. 7/28/97, 45-14 to 46-3).

E. The Reasonable Rental Rate at the Moorestown Property

43. The record is clear that until the instant objection to CPA's claim, New Valley did not contest the reasonableness of the rental terms embodied in the Moorestown Lease. (Jones Tr. 7/9/97, 88-7 to -19; Wasson Tr. 7/16/97, 107-3 to -23; Walters Tr. 7/17/97, 54-22 to 55-3). However, the court does not find that the lack of any expressed dissatisfaction by New Valley as to the rental terms resolves the question of whether the base rent for the Moorestown Property exceeds the market rent for the post-petition period.

44. Rather, after consideration of the testimony and report of New Valley's expert George W. Powell, Jr. ("Powell") and the testimony and report of CPA's expert, Maryann D. Franken ("Franken") the court finds that the

conclusions reached by Powell are more reasoned and supported by a detailed examination of the relevant market for the Moorestown Property. Thus, the court accepts Powell's conclusion that the market base rent for the Moorestown Property during the post-petition period was $7.00 per square foot "as is" based on 65,000 rentable square feet "absolute net." Consequently, the base rent of $10.85 per square foot set forth in the Moorestown Lease was unreasonable for the postpetition period. (NV-71; Powell Tr. 7/18/97 A.M., 138-18 to 139-19).

45. Powell has been an appraiser since 1978 and received a MAI designation in 1987. Powell teaches appraisal techniques at Rutgers University, has been a speaker at various conferences, including a seminar on financial aspects of Chapter 11 cases, and has testified as an expert on property valuation in various New Jersey courts. (NV-71 at 28 to 31; Powell Tr. 7/18/97 A.M., 104-20 to 107-19).

46. Franken has worked for Mertz Corporation ("Mertz") since 1988 as a licensed real estate broker and licensed sales associate. Franken first became familiar with the property in August, 1992 and is familiar with its location, layout, condition, and possible uses. (CPA-23; Franken Tr. 7/28/97 P.M., 35-5 to 45-17). However, she is not an appraiser, and has not previously testified as an expert. (Franken Tr. 7/28/97 P.M., 83-8 to -11; 85-4 to -13). Moreover, Franken testified that she arrived at her conclusion of market rent by ascertaining what she believed to be an average market rental rate for large and small spaces. (Franken Tr. 7/28/97 P.M., 103-11 to 105-22).

47. However, neither Franken's testimony nor her report identifies any specific leases or properties which she examined. Although Franken asserted that she looked at rent rolls of buildings with tenants occupying 50,000 square feet she was unable to specify any tenant or lease terms which she examined. (Franken Tr. 7/28/97 P.M., 106-8 to 110-18).

48. Additionally, she testified that "The average transaction in our marketplace in southern New Jersey in office is under 5,000 square feet. So any of these large deals are not normal deals in our marketplace. We are not a New York City or a Center City. We live on deals that are under 10,000 with the average being under 5." (Franken Tr. 7/28/97 P.M., 105-19 to 106-7). Thus, it appears to the court that Franken's conclusion as to an average market rent is an unverifiable impression based largely on transactions substantially smaller in size than the lease at issue. Accordingly, the court finds that her conclusions are not adequately supported.

49. Powell's report identifies the Moorestown Property as having a gross floor area of 71,300 square feet. Of that space 65,000 square feet is described as usable, and the remaining 6,300 square feet is described as a mechanical penthouse (NV-71 at 2). New Valley contends, and the court concurs, that calculation of the reasonable post-petition rent should be premised upon the usable 65,000 square feet. Indeed, Franken agreed that the mechanical penthouse space was not usable space, and additionally agreed that Mertz marketed the property as having 65,000 square feet. (Franken Tr. 7/28/97 P.M., 144-15 to -24).

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50. Powell considered not only the Moorestown Property, but also reviewed "commercial development and retail and office leasing activity from November 1991 to May 1993 in Mt. Laurel, Moorestown, and Evesham (Marlton) Townships, Burlington County, New Jersey and the South Jersey Regional Mall market in Burlington, Gloucester and Camden Counties, New Jersey." (NV-71 at 3).

51. Powell found that for the years 1989 through 1991 the vacancy rate for office space in Burlington County was in excess of 30% and in excess of 25% for Camden County (NV-71 at 8). He further testified:

> During the period 91 through 93, the office market in South Jersey had collapsed. The office market was fueled in the 1980s primarily through very, very handsome financing by lending institutions who were, in my opinion, attempting to place as many loans on the street as possible to collect points, reporting them in the quarterly earnings and boost their stock, thereby making them attractive during a period of bank acquisition merger frenzy. Most of the buildings were built on speculation in this 3M corridor, as we call it, which spans from Moorestown, Marlton and Mount Laurel. The office buildings were primarily constructed along Route 38 and were heavily down Route 73, which does intersect Route 38 to the west of the Moorestown Mall. During this period most of these parks, office parks were in either default and bankruptcy and foreclosure or some aspect thereof. By 1993, most had been

> foreclosed by their lenders, and were in various stages of disposition. We were active in that market in appraising many of these office buildings and parks for lenders, for trustees in bankruptcy, and it was our — and we were familiar with the activity to know that it was a flight of tenants out of South Jersey. (Powell Tr. 7/28/97 A.M., 113-13 to 114-14).

52. Powell's review of the conditions in the office and retail market in the area of the Moorestown Property, as well as his assessment of the property configuration and location led him to conclude that the appropriate market rental was the retail rate. (NV-71 at 19; Powell Tr. 7/18/97 A.M., 112-2 to -23; 114-19 to 25).

53. Powell's report contains several comparables which he adjusted for differences with the Moorestown Property to arrive at a rental rate of $7.00 per square foot, on a triple net basis. (NV-71 at 20-24).

54. Interestingly, CPA's marketing and leasing of the Moorestown Property is corroborative of Powell's conclusion. Franken testified that in 1994 she was seeking a rental rate of "$4.50 in as-is condition, and I believe that was reasonable for the condition of the property." (Franken Tr. 7/28/97 P.M., 131-4 to -7). In late 1994 she negotiated with Boundless Enterprises, Inc. for a rental rate of $5.25 per square foot for the first five years. (Franken Tr. 7/28/97 P.M., 134-15 to 136-6; NV-40B and 40C).

55. In April, 1995 Franken represented CPA in the leasing of the Moorestown Property to Sports & Recreation for retail use at a rental rate of $4.75 per square foot, triple net, for the first five years of a fifteen year lease. (Franken Tr. 7/28/97 P.M., 142-7 to 143-21; NV-29).

56. Finally, Powell confirmed the appropriateness of his conclusion as to the fair market rental rate by deriving a capitalization rate for the Moorestown Property. Both he and Franken agreed that a 12 percent capitalization rate was within the reasonable range of such rates for the property. (Powell Tr. 7/18/97 A.M., 132-6 to -23; Franken Tr. 7/28/97, 147-16 to 148-5). He assumed a fair market value of the building of $3,750,000 as reflected in a counterproposal submitted by Franken in August 1994. (NV-39E). Powell computed the net operating income to be $455,000 (65,000 sq. ft. x $7.00) and divided it by $3,750,000 to reach a capitalization rate of 12.1 percent. (Powell Tr. 7/18/97 A.M., 131-15 to -24). When Powell calculated a capitalization rate using a $3,750,000 fair market value, and a rental rate of $10.85 for 65,000 square feet he arrived at a capitalization rate of 18.8 percent. (Powell Tr. 7/18/97 A.M., 130-7 to -19). He found such a rate to be well out of the range which he has seen in the market. (Powell Tr. 7/18/97 A.M., 131-8 to -14, 136-18 to 137-13). Franken also testified that she has not seen a capitalization rate in the 18 to 20 percent range (Franken Tr. 7/28/97 P.M., 148-6 to -12).

F. CPA's Proofs of Claim

57. New Valley alleges that CPA (i) intentionally inflated the amounts sought in the Initial and Second Proofs

of Claim, (ii) intentionally and falsely claimed that the Reno and Moorestown Leases were assigned to FSI in order to avoid the restrictions on the amount of its claim in bankruptcy, and (iii) manufactured evidence to support its contention that the Leases were assigned to FSI.

1. Claim Inflation

58. CPA's first proof of claim was for $5,449,407 for leases of the Moorestown Property, the Reno Property and the Bridgeton, Missouri Property. In that proof of claim CPA sought payment for deferred maintenance as follows: $612,500 for Moorestown, $1,000,000 for Reno, and $1,000,000 for Bridgeton (CPA-3).

59. Thereafter, CPA submitted a Second Claim, which pertained solely to the Reno Property, in the amount of $2,317,497. In that proof of claim CPA claimed deferred maintenance and others costs of $1,330,000. (CPA-6).

60. New Valley attempted to demonstrate that CPA's deferred maintenance claims were substantially at odds with information in its possession.

61. New Valley correctly points out that CPA had in its possession at the time that it prepared the proofs of claim various reports that stated that the properties were in average or above average condition:

a) A "Deferred Maintenance Survey" prepared for CPA by Robert E. Lamb, Inc. for the Moorestown Property dated February 11, 1993

(six and one-half months prior to the filing of the Proof of Claim) contains detailed itemized costs necessary to complete deferred maintenance items which total $371,200. (NV-20).

b) A report of a site inspection of the Moorestown Property performed by Gerald Dayley dated August 26, 1991 (at the time New Valley had vacated the premises at Moorestown) which stated: "[t]he overall condition is good. The carpeting is well worn but the structure is in excellent condition." (NV-12).

c) A report of a site inspection of the Reno Property performed by Gerald Dayley dated April 8, 1992 (only 17 months prior to the filing of the Proof of Claim) which stated: "[t]he overall condition is excellent and shows a concern for maintaining the facility in above-average condition." (NV-16).

d) A report of a site inspection of the Bridgeton property performed by Gerald Dayley dated July 13, 1992 (only 14 months prior to the filing of the Proof of Claim) which stated: "[t]he overall condition is good and shows a concern for maintaining the facility in good condition." This site inspection report was accompanied by a cover letter from Gerald Dayley to New Valley which stated: "I hope that you can continue to maintain the facility in the same excellent condition despite Western Union's financial difficulty. (NV-18).

62. Garbus testified that the Property Management Department at W. B. Carey maintains a property inspection database which is compiled from inspection reports prepared by Gerald Dayley or others performing the inspections. (Garbus Tr. 7/10/97 A.M., 77-14 to 78-8). Thus, it appears that such reports were readily available when the CPA proofs of claims were prepared.

63. Wasson, the former Director of Real Estate Operations for New Valley also testified credibly that he performed a site inspection of the Reno facility in the fall of 1994 and found the property to be in very good shape, with all systems functioning. (Wasson Tr. 7/16/97, 78-7 to 83-11).

64. The court viewed a videotape of the Reno Property which is a visual survey of various empty rooms at the Property. (NV-95). While the videotape revealed no obvious deficiency to the court's untrained eye, the court does not find that it dispositively evidences that no deferred maintenance conditions existed.

65. The data for the Second Claim which reflected the higher deferred maintenance claim for the Reno Property was assembled by Elizabeth Wagner ("Wagner") of W. P. Carey, CPA's general partner. (Wagner Tr. 7/10/97 A.M., 187-24 to 188-11). Wagner obtained the deferred maintenance numbers from Gerald Dayley who had performed the site inspection. (Wagner Tr. 7/10/97 A.M., 195-8 to -10).

66. Wagner prepared a memo setting forth the figures for the base rent, additional rent, deferred maintenance, and tenant improvements, which was forwarded to Toby Daluz at the Reed Smith Shaw & McClay firm. In pertinent part, the memo described the deferred maintenance and tenant improvements as follows:

Deferred Maintenance Items: $330,000	
includes the following items:	
replace ceiling tiles	$20,000
paint interior	10,000
replace carpet	100,000
repair & replace wall coverings	20,000
ADA Standards	20,000
(includes drinking fountain, toilets, sinks, fire strobes and evacuation system)	
paint exterior	10,000
landscaping	5,000
parking lot repairs	30,000
roofs	115,000

Tenant Improvements: $1,000,000

(NV-12).

67. When the figures provided by Wagner were incorporated into the Second Claim for the Reno Property, her deferred maintenance and tenant improvement numbers were combined into a single amount of $1,330,000 and characterized as "Deferred Maintenance, Repairs and Other Costs Associated with Vacating the Premises." (CPA-6).

68. Precisely who authorized the amount and description in the Second Claim is frustratingly unclear. Barclay Jones testified that he made the judgment call on the amount of the proof of the claim, yet he concedes that he signed the claim form in blank, before it was completed. (Jones Tr. 7/9/97 P.M., 133-23 to 134-5); Jones Tr. 7/16/97, 271-25 to 272-25). Jones testified that to compute the Reno deferred maintenance claim they used an estimate of about $25.00 per square foot to put the Property in what he characterized as a "vanilla shell" condition. (Jones Tr. 7/9/97 P.M., 132-16 to 133-4). Further he testified that he conferred with Wagner and Dayley to arrive at the square footage estimate. (Jones Tr. 7/9/97 P.M., 133-25 to 134-5). However, Wagner stated that she did not discuss the calculation of the claim with anyone at CPA or W.P. Carey after she prepared the numbers for inclusion in the memo to Toby Daluz. (Wagner Tr. 7/10/97 A.M., 235-20 to 236-2). Also perplexing is the fact that nothing in NV-11, NV-12 or CPA-6 references an estimate of $25.00 per square foot for deferred maintenance.

69. As mentioned above, Jones asserts that the deferred maintenance item was intended to reflect the cost of bringing the property to a vanilla shell. He further testified that a landlord can only estimate those costs because it is not possible to be certain until work is begun on a property. (Jones Tr. 7/16/97, 311-3 to 312-5). Moreover, he claims that the estimate for the Reno property was in part based on CPA's experience at Moorestown as well as other properties. (Jones Tr. 7/9/97 P.M., 129-5 to -7, 131-11 to -21; 132-9 to 133-15).

70. After carefully considering the conduct of CPA in preparation of the proofs of claim, the court concludes that

CPA was remarkably indifferent to precisely calculating a reasonable estimate of its claim, and also took a somewhat expansive view of what constitutes deferred maintenance. However, in light of the testimony that the deferred maintenance estimates were premised upon putting the property in a "vanilla shell" condition and that the estimates were derived in part from actual experience from other buildings the court cannot find a deliberate intent to misstate deferred maintenance claims for the Reno and Moorestown Properties. Thus, the court does not find that CPA deliberately inflated its proofs if claim.

2. Alleged Assignment of the Leases to CPA

71. New Valley contends that the evidence shows that CPA intentionally and falsely maintained that the Reno and Bridgeton Leases were assigned. Further, to bolster its position CPA manufactured documents which purportedly demonstrate that CPA consented to the assignments. After considering the testimony of the witnesses, particularly that of Barclay Jones, Donald Wasson, and John Walters, and the exhibits submitted into evidence by the parties, the court concludes that New Valley's contention has been proven by a preponderance of the evidence. That is, as set forth below, the court finds that CPA never considered the leases to have been assigned. The court suspects that CPA took that position as a negotiating tactic in order to minimize any losses it might suffer as a result of the New Valley bankruptcy.

72. On March 15, 1990 Wasson wrote to Jones to request that CPA consent to the assignment of the Bridgeton and Reno leases to FSI. Wasson included the proposed consents

to assignment with his letter. (Wasson Tr. 7/16/97, 30-18 to 33-10; NV-46; CPA-7).

73. In April, 1990 Wasson and Jones discussed the proposed consents. Jones advised Wasson that CPA refused to execute the consents unless the Moorestown Lease was also assigned to FSI. (Wasson Tr. 7/16/97, 33-11 to 38-9; Jones Tr. 7/9/97 P.M., 154-9 to 13).

74. Jones testified unequivocally that he did not reach any deal with Wasson regarding CPA's consent to the assignments. (Jones Tr. 7/9/97 P.M., 213-2 to 214-11). Wasson also understood that CPA did not consent to the assignments. He advised his colleague, Jan Wolpert, by memo dated April 12, 1990 that CPA wanted all of the properties to be transferred to FSI. Wasson further asked Wolpert how he wished to proceed. (NV-47). Wasson further testified that from that point through May, 1993, there were no discussions between New Valley and CPA regarding assignment of the Bridgeton and Reno Leases. (Wasson Tr. 7/16/97, 40-16 to 40-17; Jones Tr. 7/9/97 P.M., 155-5 to -18).

75. In April, 1993, shortly after the entry of the order for relief in its Chapter 11 case, New Valley moved to extend the time to assume or reject nonresidential real property leases (including the Bridgeton and Reno Leases until confirmation of a plan of reorganization. (NV-96-1).

76. CPA initially objected to the relief sought, but on May 18, 1993 advised New Valley that its objection would be withdrawn. CPA's counsel faxed copies of consents to

assignment, executed by Barclay Jones, and dated April 15, 1990, to the New Valley bankruptcy counsel. (Walters Tr. 7/17/97, 16-16 to 17-12). On May 21, 1993 CPA filed a Withdrawal of Objection. (NV-96-5).

77. After receiving faxed copies of the consents from the New Valley bankruptcy counsel, John Walters ("Walters") the general counsel to New Valley, directed Wasson to check the New Valley Files for any fully executed copies of the consents. Wasson found that the New Valley files did not contain any such documents. (Walters Tr. 7/17/97, 22-2 to -10; Wasson Tr. 7/16/97, 43-18 to 44-14).

78. Walters concluded that (i) CPA believed that it held valid consents to assignment, (ii) that the consents had been backdated by three years and (iii) the executed consents were "resurfaced" by CPA because with FSI as the assignee, CPA no longer had to worry whether New Valley would reject the leases. (Walters Tr. 7/17/97, 24-7 to 25-3).

79. The court concurs with Walters' assessment that it is likely that the consents were backdated and then produced to avoid the prospect of being limited to a lease rejection claim in the New Valley bankruptcy.

80. New Valley presented testimony by Richard Brunelle ("Brunelle") as an ink analysis expert. The specific scope of his engagement was to ascertain whether Jones' signature, his title, "Executive Vice President," and the date "April 15, 1990" on the original consent forms were written on April 15, 1990 or some other date. (Brunelle Tr. 7/17/97, 53-12 to -25).

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81. After conducting tests on the inks used to write the signature, title and date, Brunelle found no conclusive time frame for Jones' signature. (Brunelle Tr. 7/17/97, 44-3 to -15. However, he was able to identify the ink used to write the title and date as BIC blue ball-point ink. (Brunelle Tr. 7/17/97, 44-16 to 45-7). After performing ink dryness tests Brunelle concluded that the title and date were written in 1993. (Brunelle Tr. 7/17/97, 44-16 to 48-5; NV-99).

82. CPA did not introduce an expert to contradict Brunelle and were not able on cross-examination to demonstrate that either Brunelle's methods or conclusions were unreliable. Brunelle has conducted ink analysis since 1978 and his services and methods have been relied upon by the Internal Revenue Service, the Secret Service, and other agencies. (NV-97). The court accepts his conclusions.

83. New Valley also adduced evidence that Jones did not become Executive Vice President of W.P. Carey until April 4, 1991, approximately one year after the purported execution of the consents. (NV-89). At trial, Jones testified that he became Executive Vice President in June or July, 1990. (Jones Tr. 7/9/97 P.M., 205-5 to -13). Either date is after the date that appears on the consents.

84. In support of CPA's position that the consents were not deliberately backdated, Jones testified that a tremendous quantity of paper flowed through his offices and he very often signed documents which were then completed by others as to date and title. (Jones Tr. 7/9/97 P.M., 163-14 to 164-15; 165-2 to -20). Moreover, Elizabeth Wagner testified that

other officers at CPA followed the same practice. (Wagner Tr. 7/10/97 A.M., 252-21 to 253-3).

85. Jones did recollect signing the consents despite this voluminous paper flow. (Jones Tr. 7/9/97 P.M., 162-22 to 163-4). However, he could not remember when he signed them, though he believed it possible that he in fact signed them on Easter Sunday, April 15, 1990. (Jones Tr. 7/9/97 P.M., 164-16 to 25).

86. Jones also stated that the titles and dates on the consents were not in his handwriting. (Jones Tr. 7/9/97 P.M., 163-10 to -13). Eve Berman, the former head of the property management department at W.P. Carey, testified that the title and date on the consents are her handwriting. (Berman Tr. 7/17/97 P.M., 14-3 to -24). However, she did not recall filling out the title and date information. (Berman Tr. 7/17/97 P.M., 17-19 to -21

87. In fact, except for the identification of her handwriting on the consents Berman's testimony was largely inconclusive and unhelpful as demonstrated by the following:

> Q: Is it possible that the specific date that's on the consents is not the exact date that you actually wrote that date out?
>
> A: Yes
>
> Q: Is it possible that the date is — that you wrote on the consent to assignments three years earlier than you actually dated the document?

A: No, I highly doubt that.

Q: Well, why do you doubt that?

A: Because I doubt I would ever get a date wrong by three years.

Q: Were you ever asked by anyone to backdate any document at CPA?

A: No.

Q: Specifically, were you asked by Mr. Jones to backdate these consents?

A: No

(Berman Tr. 7/17/97 P.M., 21-18 to 22-10).

Q: Okay. And if (Mr. Brunelle) said that the ink scientifically shows that it was penned in 1993, do you have any personal knowledge that scientific evidence is flawed?

A: When was it — if it was a year different than the actual document is dated I would have to trust my date as opposed to what he says.

Q: Why?

A: Because, I mean, I don't know how accurate these scientists are but I just know that when I

> sign a document I would rarely get the year wrong. I mean, maybe the date but — unless it was like a January date where, you know you confuse January and December. I can't see why I would get the year wrong. I don't — you know, I don't know how accurate he is.

(Berman Tr. 7/17/97 P.M., 31-15 to 32-6)

88. The court is unsurprised that Berman did not recall any specifics about the consents. Nothing on the record indicates that she participated in the decision-making with regard to New Valley's request for CPA to execute the consents. Thus, the consents simply would not have any particular significance to her and would not stand-out from any other group of documents, particularly after the lapse of a few years.

89. On the other hand, the court does not find Jones' lack of memory to be credible. As amply spread out in the record Jones is not only knowledgeable and astute as to the acquisition and development of commercial real estate, but he was also the final authority with respect to the New Valley leases. He authorized and signed the proofs of claim, he interacted with CPA's bankruptcy counsel regarding the CPA claims, he was the one to whom Garbus and Wagner reported regarding the New Valley leased properties, and he was the CPA representative who discussed the terms for execution of the consents with Wasson. The court simply does not find it likely that he could not more specifically identify when he signed the consents.

90. Also remarkable is the lack of any explanation as to why CPA did not tender the allegedly executed consents to New Valley.

91. CPA's course of action becomes more understandable when considered against the backdrop of New Valley's financial difficulties both pre-bankruptcy and afterwards. As New Valley points out its lengthy history of financial difficulty and involuntary bankruptcy were well known. When New Valley filed its motion to extend the time to assume the Moorestown, Reno and Bridgeton Leases, and CPA had miraculously uncovered the executed consents, New Valley was in the early stages of its voluntary case, the outcome of which was unknown, and FSI was a solvent non-debtor subsidiary. The attractiveness of FSI as a tenant rather than New Valley is readily apparent. Again, as New Valley points out, Jones knew that while § 365 and 502(b)(6) of the Bankruptcy Code would limit CPA's claims in the New Valley bankruptcy, no such limitation existed if FSI was the tenant. (Jones Tr. 7/9/97 P.M., 215-6 to 217-16).

92. The court is also not persuaded that either Jones or CPA as an entity were confused as to whether New Valley or FSI was the tenant at the Bridgeton and Reno Properties. Both Garbus and Jones indicated a lack of knowledge as to any distinction between New Valley and FSI. (Jones Tr. 7/9/97 A.M., 52-6 to 18, 168-4 to -19; Garbus Tr. 7/10/97, 50-13 to 52-18). The court readily credits Garbus' testimony on this point, as the distinctions would be unimportant and likely imperceptible from the standpoint of day to day property management since there was no accompanying change in the use of the facilities. However, from Jones'

standpoint as the officer ultimately responsible for the financial performance of the Bridgeton and Reno Leases the distinctions are very important. In light of Jones' testimony as to his detailed oversight of the properties it is inconceivable to the court that he would have remained "confused" as to whether New Valley or FSI was the tenant.

93. Moreover, as was demonstrated through Jones' testimony and exhibits introduced by New Valley, ample documentation existed which verified that New Valley was the tenant at Reno and Bridgeton.

(i) Accountants on behalf of CPA requested and received confirmation from New Valley (and prior to the name change, from Western Union) that it was the tenant for the Bridgeton and Reno Leases as of December 31, 1991, December 31, 1992 and December 31, 1994. (Jones Tr. 7/9/97 P.M., 220-3 to 222-3; NV-60, 62, 69).

(ii) CPA prepared, requested and received from New Valley a Tenant Estoppel Certificate for the Reno Property dated July 21, 1993 which affirmatively states that the lease was not assigned. (Jones Tr. 7/9/97 P.M., 222-13 to 225-17; NV-66).

(iii) In September of 1990 (5 months after the Consents were allegedly dated), New Valley subleased a portion of the Reno space to AT&T with CPA's consent. CPA did not contend that it did not make sense to negotiate a sublease at the

Reno Property by New Valley to AT&T inasmuch as the Lease had already been assigned by New Valley to FSI. (Jones Tr. 7/9/97 P.M., 225-18 to 227-7; NV 55).

(iv) CPA sent periodic notices of rental increases to New Valley and acknowledges never sending such a notice or any correspondence to FSI. (Jones Tr. 7/9/97 P.M., 228-10 to 229-8; NV-58).

(v) CPA sent communications to its investors and filed documents with the Securities and Exchange Commission acknowledging that New Valley was its tenant and that CPA expected that New Valley would "affirm" the Bridgeton and Reno Leases and that such leases would remain in effect. CPA did *not* communicate to its investors that it believed that the Bridgeton and Reno Leases had been assigned to FSI. (Jones, Tr. 7/9/97 P.M., 229-22 to 234-11; NV-11).

94. New Valley claims that as a consequence of CPA's alleged misconduct in (i) submitting inflated proofs of claim and (ii) falsely asserting that the Bridgeton and Reno Leases were assigned New Valley has incurred legal fees of $850,000 for prosecution of its objection to the CPA claim. (Bell Tr. 7/18/97 A.M., 20-17 to 21-20). Accordingly New Valley requests that the court deny CPA's claim in its entirety.

Appendix C

CONCLUSIONS OF LAW

A. *Additional Rent*

In an opinion dated October 29, 1996 this court previously decided various legal issues which bear upon the computation of CPA's claim. Among the determinations reached, the court concluded that CPA is entitled to include items of additional rent as well a base rent in its proofs of claim for rent due under the Reno and Moorestown Leases. Subsequently, New Valley stipulated to the inclusion of a number of expense items incurred in connection with both leases as additional rent. However, it objected to inclusion of CPA's cost or retaining maintenance men for the Reno and Moorestown Properties. Specifically, New Valley contends that CPA's claim should be reduced by elimination of maintenance men chosen as follows: (i) $10,912.50 for the maintenance man component of the Reno Lease, (ii) $6,000.00 for the maintenance man component of the Gap Claim additional rent on the Moorestown Lease, and (iii) $18,582.35 for the maintenance man component of the Rejection Damages Claim for additional rent on the Moorestown Lease.

Two approaches exist for determination of what expense items should be included as "rent reserved" under the lease as that item is used in § 502(b)(6)(A). The court in *In re Conston Corp.*, 130 B.R. 449, 455 (Bankr. E.D.Pa. 1991) concluded that additional rent items may be classified as "rent reserved" if the lease expressly provides for the charges in question, and the charges are regular, fixed periodic charges payable in the same way as "pure rent." Applying this

formula, the court found that utility charges were properly considered to be rent. *Id.* A somewhat more flexible test is stated in *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91 (9th Cir. BAP 1995). *McSheridan* holds that the following test must be applied to determine if additional rent constitutes "rent reserved" under § 502 (b)(6)(A):

> 1) The charge must (a) be designated as "rent" or "additional rent" in the lease; or (b) be provided as the tenant's/lessee's obligation in the lease;
>
> 2) The charge must be related to the value of the property or the lease thereon; and
>
> 3) The charge must be properly classifiable as rent because it is a fixed, regular or periodic charge.

McSheridan, 184 B.R. at 99-100. Similarly, the court in *In re Rose's Stores, Inc.*, 179 B.R. 789, 791 (Bankr. D.S.C. 1995) determined that the expense sought as rent need not be specifically denominated as rent, but must be provided for in the lease as the tenant's obligation. Unlike *McSheridan*, however, it did not impose the additional requirement that the change be fixed, regular or periodic.

As stated in its earlier decision, this court finds that the test enunciated in *McSheridan* provides the best guidance in determining what items sought as additional rent properly fall within the ambit of § 502(b)(6)(A).

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Neither the Moorestown Lease nor the Reno Lease expressly denominate the tenant's maintenance obligation as an item of rent or additional rent. However, both leases are triple net leases and make the tenant responsible for all expenses necessary to maintain, upkeep and operate the properties. Thus, the first part of the *McSheridan* test is met.

However, CPA has not established that the maintenance men expense was directly related to the value of the property or the lease. The testimony by CPA's witnesses certainly established their belief that on-site maintenance persons were essential to its effective management of the Reno and Moorestown properties. However, it does not follow from that premise that the compensation paid to the maintenance men is related to the value of the property in the same manner as, for example, landscape services or security services which are direct and actual expenses of maintenance and preservation. From the testimony it appears that CPA relied upon the maintenance men to monitor the performance of various maintenance items. As Ms. Garbus stated, they were CPA's "eyes and ears." Thus, in essence, the maintenance men satisfied CPA's desire to be sure that the properties were maintained in a manner CPA considered satisfactory. As such, the expense is one incurred by CPA in furtherance of what it apparently considered to be its management responsibility. The fact that the compensation paid to the maintenance men were fixed, periodic payments does not strengthen CPA's argument. Applying CPA's construction of permissible additional rent would also permit CPA to include the salary of the individual at CPA who reviewed the expenses of the properties and authorized payment, since arguably that function also contributes to the preservation

of the value of the property. In short, CPA's interpretation of additional rent is overbroad.

B. *Effective Rejection Date of the Moorestown Lease*

New Valley contends that the effective date of the rejection of the Moorestown Lease was not later than February 25, 1993 when Wasson inspected the Moorestown Property and observed CPA authorized workmen performing services on CPA's behalf. On the other hand, CPA argues that the effective date of rejection was May 24, 1993, when the order authorizing rejection was entered. The financial impact of which date should be deemed the effective date is significant, as a determination that the February 25, 1993 date is the effective date results in a reduction of the CPA claim by more than $200,000.

Section 365(d)(3) requires timely performance of all obligations of a debtor under an unexpired lease until, subject to the court's approval, such lease is assumed or rejected. Thus, as it acknowledges, New Valley was obligated to pay post-petition rent until the effective date of the rejection of the Moorestown Lease.

Because the statute is silent on the subject, courts have reached different conclusions as to whether court approval is a condition precedent or subsequent to an effective rejection under section 365. The majority of courts have held that court approval is a condition precedent to the effective rejection of a nonresidential lease. *In re Thinking Machines Corporation*, 67 F.3d 1021, 1025 (1st Cir. 1995); *In re Amber's Stores, Inc.*, 193 B.R. 819, 826 (Bankr. N.D. Tex.

1996); *In re Appliance Store, Inc.*, 148 B.R. 226, 232 (Bankr. W.D. Pa. 1992); *In re Revco D.S., Inc.*, 109 B.R. 264, 270 (Bankr. N.D. Ohio 1989). A minority of courts have determined that court approval is a condition subsequent to the trustee's or debtor's communication to the landlord of the determination to reject. *By-Rite Distrib., Inc. v. Brierly (In re By-Rite Distrib, Inc.)*, 55 B.R. 740, 742 (D. Utah 1985); *In re 1 Potato 2, Inc.*, 58 B.R. 752, 755-56 (Bankr. D. Minn. 1996); *In re Joseph C. Spiess Co.*, 145 B.R. 597, 604 (Bankr. N.D. Ill. 1992).

The court finds persuasive the reasoning which informs the conclusion reached by the majority of courts addressing the issue, that court approval is a condition precedent to effective rejection of a lease under section 365(a). In particular, the court concurs with, and adopts the analysis made by the first Circuit in *Thinking Machines*, including its conclusion that a court may authorize a rejection that is retroactive to a date that is earlier that the date of the order approving the rejection. 67 F.3d at 1028.

The exercise of a court's equitable powers is inherently fact specific and must be guided by the notion of fairness so as to avoid unfair prejudice to any party. "In the 365 context, this means that bankruptcy courts may enter retroactive orders of approval, and should do so when the balance of equities preponderates in favor of such remediation." *Thinking Machines*, 67 F.3d at 1028 (citing to *In re Jamesway Corp.*, 179 B.R. 33, 39 (S.D.N.Y. 1995)).

After examining the facts of this case, the court finds that rejection of the Moorestown should be retroactive to February 23, 1993.

Appendix C

As a preliminary matter, the court finds that New Valley's failure to request retroactive approval at the time of the original motion does not bar them from such relief now. CPA is not prejudiced by the delayed request, as the same arguments that could have been marshalled in opposition can as easily be raised now.

Turning to the facts, the record amply establishes that CPA knew in April, 1989 that New Valley was terminating its operations at the Moorestown Property. By the summer of 1991 CPA had replaced New Valley's broker with one of its own which was actively showing the property. By February of 1993, not only had New Valley completely vacated the premises but CPA had also commenced construction work to prepare the space for a new tenant. Thus, by the time of Wasson's site inspection on February 25, 1993 it is evident that CPA was fully in control of the Moorestown Property. As New Valley points out, CPA was not in the position of the typical landlord who refrains from action because it cannot be certain of its rights and until entry of the order authorizing rejection. On these facts, had New Valley made the request in its motion to reject, this court would have authorized rejection retroactive to February 25, 1993. It sees ample basis to do so now.

C. *The Moorestown Lease Rate in the Postpetition Period is Unreasonable*

New Valley contends that the market base rent for the postpetition period from November 5, 1991 through the rejection date ("Postpetition Period") did not exceed $7.00 per square foot, and the lease rate is therefore unreasonable.

CPA rejects the New Valley position and argues that the base rent of $10.85 per square foot contained in the Moorestown Lease is within the range of market rate rents and is therefore reasonable.

In general, there is a presumption that the rent fixed in the lease is the reasonable rental value of a property. *In re Thompson*, 788 F.2d 560, 563 (9th Cir. 1986); *In re F. A. Potts & Co., Inc.*, 137 B.R. 13, 18 (Bankr. E.D. Pa. 1992); *In re Mohawk Industries, Inc.*, 54 B.R. 409, 412 (Bankr. D. Mass 1985). However, as noticed by the court in *Potts* that presumption does not control if "there is convincing evidence that such rental rate is unreasonable." 137 B.R. at 18; accord *Mohawk*, 54 B.R. at 412; *Thompson*, 788 F.2d at 563 ("fair and reasonable value of the lease upon the open market" is determinative of reasonable value, not "the actual value or benefit conferred on the debtor").

As set forth in its findings of fact, the court finds that New Valley's expert made a detailed and well supported examination of the market rents in the postpetition period which established that the rate set in the Moorestown Lease was greater than that which obtained in the market, and was therefore unreasonable. In fact, the reletting of the premises by CPA actually confirms Powell's expert opinion. Accordingly, New Valley has met its burden of demonstrating by convincing evidence, that the lease rental rate in the post-petition period was unreasonable. *In re Schnabel*, 612 F.2d 315, 318 (7th Cir. 1980).

Appendix C

D. *CPA's Conduct Does not Warrant Disallowance of its Claim*

New Valley contends that CPA (i) intentionally inflated its proofs of claim, (ii) falsely claimed that the Reno and Moorestown Leases had been assigned to FSI, a non-debtor subsidiary of New Valley, and (iii) executed and back-dated consents to assignment of the leases to support its claim that the leases were assigned. CPA vigorously denies that the proofs of claim were inflated or that they did not have a reasonable belief that the Reno and Moorestown Leases had been assigned to FSI.

It is true, as New Valley observes, the bankruptcy courts as courts of equity may apply equitable principles in order to achieve fairness and justice in the administration of the estate. *Pepper v. Litton*, 308 U.S. 295, 304, 307-308 (1939); *Bank of Marin v. England*, 385 U.S. 99, 103 (1966). Thus in *Pepper v. Litton*, the Supreme Court held that equitable subordination was a proper remedy for a claim acquired by fraud. So too the Second Circuit, in *Margolis v. Nazareth Fair Grounds Farmers Market*, 249 F.2d 221, 224-25 (2d Cir. 1957) affirmed the lower court's determination that where there was evidence that the claims were based on judgments procured by fraud the court could look behind the judgments for purposes of disallowing the claims. Importantly, in both of the foregoing cases the result was dictated by the egregiousness of the conduct of the claimants.

In the present matter, it is not readily apparent that CPA intentionally inflated the proofs of claim. The deferred maintenance claims were not capable of exact calculation as

they naturally require estimates of the goods and services required to bring the leaseholds to a vanilla box condition. It is also certainly true that parties will often disagree as to what expenses may properly be claimed. From the testimony, it appeared to the court that CPA employed a generous definition of deferred maintenance and performed its calculations in very broadstrokes and in a manner most favorable to it. Indeed, it seemed to the court from Jones testimony that CPA expected New Valley to disagree with its claim as to some elements, and that it was surprised only by the vehemence with which New Valley objected. In short, it appears to the court that CPA filed claims which contained components that were intentionally calculated in a manner more favorable to it than New Valley. However, while such activity makes the claim ripe for attack under the claims objection process it does not make it a fraud on New Valley or the bankruptcy process.

As to the consents to assignment of the Reno and Moorestown Leases, the court is wholly unconvinced that CPA actually believed that the Moorestown and Reno Leases had been assigned. The Jones testimony as to his confusion is unconvincing as it is not supported by the facts and appears inconsistent with his knowledge and abilities. The court finds that the expert testimony convincingly demonstrates that the consents were backdated. If the court had before it litigation between FSI and CPA as to the validity of the assignments New Valley's position would be well taken.

Nonetheless, the court perceives no impact on the proofs of claim filed in the New Valley case since the alleged assignments did not bear on any element of the proof of

claim. Without more they are not sufficient circumstantial evidence that CPA concocted an inflated claim. Rather, it appears to have been a somewhat misguided effort to preserve a right against FSI in the event CPA was unlikely to be paid in the New Valley case.

New Valley posits that both the assertion of the assignment and alleged claim inflation prolonged the claims resolution process and caused New Valley to expend unnecessary legal fees. Such a position fails to recognize the many issues that were addressed by the parties and the court in the earlier summary judgment motion. They involved unsettled legal issues which substantially affected the size of CPA's claim. For example, after both parties fully briefed the issue the court determined that deferred maintenance expenses were included within the statutory cap. It was this issue and other complex matters that primarily prolonged this claim objection, and not CPA's conduct. Thus, the court finds unwarranted New Valley's position that CPA's claim should be disallowed because of CPA's conduct.

Moreover, though the court is skeptical as to Jones' lack of memory regarding execution of the consents to assignment of the Reno and Moorestown leases and agrees with New Valley's contention that CPA's position that the assignments had occurred is utterly lacking in merit. The court nonetheless finds that CPA's conduct as to its assertion of a claim against FSI is dispositive of its conduct as to its claims against New Valley. If the court had before it an objection by FSI to a CPA claim the issues surrounding execution of the consents would be directly pertinent. In connection with the CPA claim against New Valley it has less weight and simply does

not provide sufficient basis to conclude that the CPA claims against New Valley were inflated.

CONCLUSION

New Valley objected that CPA improperly included additional one-half month in the calculation of its base rent claim under the Moorestown Lease. As set forth above, the court disagrees with the New Valley objection and makes no disallowance on this basis.

New Valley also objected to the inclusion of charges for maintenance as part of the additional rent under both the Reno and Moorestown Leases. The court sustains this New Valley objection. Consequently, CPA's claim is reduced by (i) $10,912.50 for the maintenance man component of additional rent on the Reno Lease, (ii) $6,000.00 for the maintenance man component of the Gap Claim for additional rent on the Moorestown Lease, and (iii) $18,582.35 for the maintenance man component of the rejection damages claim for additional rent on the Moorestown Lease. The reduction of the CPA claim for disallowance of the maintenance man expense totals $35,494.85.

New Valley also argued that CPA made an arithmetical error in its computation of the post-rejection real property tax component for the Moorestown Property, by including $45,982.61 in the calculation. As set forth above, the court finds that CPA properly included second quarter 1993 taxes in its computation, and the court therefore denies New Valley's objection. However, it also appears that CPA included the second quarter 1993 taxes in its calculation of

taxes for the pre-rejection period. Accordingly, the total pre-rejection taxes should be reduced to $142,320.14.

New Valley also contended that the Moorestown Lease rejection should be effective as of February 25, 1993. Thus, the GAP claim for the Moorestown Lease is reduced by one an one-half month's base rent and one and one-half month's additional rent for a total of $101,620.66.[1] Moreover, as a result of the court's ruling CPA's Administrative Claim is eliminated, thereby further reducing the CPA claim by $173,478.40

A major objection advanced by New Valley was directed at the reasonableness of the rent for the Moorestown Lease in the post-petition period. As set forth above, the court sustained New Valley's objection and found the market rate rent for the post-petition period to be $7.00 per square foot, rather than $10.35 per square foot. The court calculates this reduction of the claim for the Moorestown property to be $254,042.[2]

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1. This calculation is premised on base rent at $58,513.19 per month and additional rent at $9,233.92 per month.

2. The court calculated the reduction in the Moorestown Lease for the post-petition period as follows: 65,000 sq. ft. x $10.35 per sq. ft. = $672,750 per annum. $672,750 divided by 12 = $56,062.50. The time period involved is December, 1991 through February, 1993, for a period of 14 months. Thus, the total rent at $10.35 per sq. ft. would equal $784,875. At $7.00 per sq. ft. x 65,000 sq. ft. the annual rent equals $455,000. $455,000 divided by 12 = $37,916.66. For the time period in question at $37,916.66 the total rent equals $530,833.24. The difference between $784,875 and $530,833.24 equals $254,042.

Appendix C

After applying all of the deductions itemized above to the CPA claims which total $3,499,084.84, the court arrives at an allowed claim for both the Reno and Moorestown Leases in the amount of $2,888,469.30.

Dated: December 23, 1997

s/ Novalyn L. Winfield
NOVALYN L. WINFIELD
U. S. Bankruptcy Judge

APPENDIX D — ORDER OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF NEW JERSEY DATED JANUARY 26, 1998

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW JERSEY

(Honorable Novalyn L. Winfield)

Chapter 11

Case No. 91-27704 (NLW)

In re

NEW VALLEY CORPORATION,

Debtor.

ORDER

This court conducted an evidentiary hearing on the objections (the "Objections") filed by New Valley Corporation ("New Valley") to the proofs of claim (the "CPA Claims) filed by Corporate Property Associates 2 and 3 ("CPA") against New Valley for amounts owing, *inter alia*, under an Indenture of Lease for real property located at 308 West Route 38, Moorestown, New Jersey and under an Indenture of Lease for real property located at 5025 Mill Street, Reno, Nevada. On December 23, 1997, this Court issued an opinion (the "Opinion") setting forth its findings of fact and conclusions of law with respect to the Objections and the amount of the CPA Claims.

NOW THEREFORE, for the reasons set forth in the Opinion, it is hereby

ORDERED, ADJUDGED and DECREED that the CPA Claims, in the aggregate, are allowed in the amount of $2,888,469.30.

Dated: Newark, New Jersey
January 26, 1998

s/ Novalyn L. Winfield
NOVALYN L. WINFIELD
United States Bankruptcy Judge

APPENDIX E — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT DENYING PETITION FOR REHEARING DATED AUGUST 27, 1999

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 98-6267

IN RE: NEW VALLEY CORPORATION,

Debtor

NEW VALLEY CORPORATION,
c/o BROOKE GROUP LTD.

Appellee

v.

CORPORATE PROPERTY ASSOCIATES 2 AND 3,
c/o W.P. CAREY & COMPANY, INC.

Corporate Property Associates 2 and 3,

Appellants

SUR PETITION FOR REHEARING

Present: BECKER, *CHIEF JUDGE*,
SLOVITER, MANSMANN, GREENBERG, SCIRICA,
NYGAARD, ALITO, ROTH, McKEE, RENDELL,
and GARTH* *Circuit Judges.*

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* Senior Circuit Judge Garth's vote is limited to rehearing before the original panel only.

Appendix E

The petition for rehearing filed by Appellee in the above entitled case having been submitted to the judges who participated in the decision of this court and to all other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT,

s/ Theodore A. McKee
Circuit Judge
Hon. Theodore A. McKee

AUG 27 1999

APPENDIX F — RELEVANT STATUTE

11 U.S.C. § 502

§ 502. Allowance of claims or interests

(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that —

(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;

(2) such claim is for unmatured interest;

(3) if such claim is for a tax assessed against property of the estate, such claim exceeds the value of the interest of the estate in such property;

(4) if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services;

(5) such claim is for a debt that is unmatured on the date of the filing of the petition and that is excepted from discharge under section 523(a)(5) of this title;

(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds —

(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of —

(i) the date of the filing of the petition; and

(ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus

(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;

(7) if such claim is the claim of an employee for damages resulting from the termination of an employment contract, such claim exceeds —

(A) the compensation provided by such contract, without acceleration, for one year following the earlier of —

(i) the date of the filing of the petition; or

(ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus

(B) any unpaid compensation due under such contract, without acceleration, on the earlier of such dates;

(8) such claim results from a reduction, due to late payment, in the amount of an otherwise applicable credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor; or

(9) proof of such claim is not timely filed, except to the extent tardily filed as permitted under paragraph (1), (2), or (3) of section 726(a) of this title or under the Federal Rules of Bankruptcy Procedure, except that a claim of a governmental unit shall be timely filed if it is filed

before 180 days after the date of the order for relief or such later time as the Federal Rules of Bankruptcy Procedure may provide.

(c) There shall be estimated for purpose of allowance under this section —

(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or

(2) any right to payment arising from a right to an equitable remedy for breach of performance.

(d) Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

(e)(1) Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured, the claim of a creditor, to the extent that —

(A) such creditor's claim against the estate is disallowed;

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or

(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

(f) In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(g) A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(h) A claim arising from the recovery of property under section 522, 550, or 553 of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(i) A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(j) A claim that has been allowed or disallowed may be reconsidered for cause. A reconsidered claim may be allowed or disallowed according to the equities of the case. Reconsideration of a claim under this subsection does not affect the validity of any payment or transfer from the estate made to a holder of an allowed claim on account of such allowed claim that is not reconsidered, but if a reconsidered claim is allowed and is of the same class as such holder's

claim, such holder may not receive any additional payment or transfer from the estate on account of such holder's allowed claim until the holder of such reconsidered and allowed claim receives payment on account of such claim proportionate in value to that already received by such other holder. This subsection does not alter or modify the trustee's right to recover from a creditor any excess payment or transfer made to such creditor.

* * * *